**Reply to December 22, 1998 Draft Report of**
**The Federal Communications Commission Accounting Safeguards Division**
**Audit of Nevada Bell, Pacific Bell**
**and Southwestern Bell Telephone Company**

January 11, 1999

**JOINT RESPONSE OF**
**NEVADA BELL**
**PACIFIC BELL**
**SOUTHWESTERN BELL TELEPHONE COMPANY**
**(SBC LECs)**

Note: Since the FCC Audits Branch provided copies of the December 22, 1998 draft Audit Reports to the SBC LECs for limited comment, this document is a response of the report and recommendations noted in that report but does not constitute a complete and final response to the findings, allegations and recommendations in that report.

# CONTENTS OF JOINT REPONSE OF SBC LECs

# I. EXECUTIVE SUMMARY AND RESPONSE TO THE FCC'S RECOMMENDATIONS

## EXECUTIVE SUMMARY

**This executive summary describes the attached response to the Federal Communications Commission's continuing property records (CPR) audits of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell (the SBC LECs). First, the audit reports are simply wrong. Second, even if true, the audit results have no impact on consumers, or the prices they pay. Third, the CPR audit process wastes government and corporate resources that should be committed to achieving the goals of the Federal Telecommunications Act. Fourth, the audits extend the inequitable regulatory treatment of LECs, because FCC obligates no other competitors in the telecommunications industry to comply with CPR audit requirements. Considering the FCC's well known commitment to forward-looking costs, SBC LECs find surprising the FCC's sudden attention to backward-looking audits of assets governed by an antiquated regulatory process and a 30 year-old agreement.**

**There are no serious deficiencies in the continuing property records of Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell**, as alleged in the FCC Audit Reports. The SBC LECs have sufficient and adequate practices, procedures, and controls to assure that their investment is accurately stated on their books, and have complied with FCC audit precedents and requirements established over 30 years ago.

**The Audit Reports exaggerate the magnitude of any errors that may exist.** As SBC states in its response, auditors gave no consideration to actual Statewide Asset Validation and Retirement (SAVR) project inventory process and results of these inventories reflecting more than 97% compliance at Pacific Bell and SWBT. Auditors also failed to consider many other critical aspects of a true and fair audit process by:

- counting as seriously deficient equipment that was not in the precise location described in the companies' paperwork;
- disregarding the existence of new equipment that had not yet been added to the companies' paperwork;
- neglecting consideration of SBC's efforts to identify, methodically and with notice to the FCC, the billions of dollars of undetailed assets transferred between AT&T and the BOCs following divestiture;
- failing to adjust their audit procedures or statistical methods despite evidence that FCC audit data does not achieve accepted margins of error

or confidence levels; indeed, some margins of error vary between 40% and 50%; and,

- abandoning Generally Accepted Audit Standards (GAAS) which recommends completing detailed systems walk throughs/reviews prior to the establishment of an audit plan to perform audit field work.

**Under price cap regulation, errors in the plant account balances are immaterial in the ratemaking process.** This audit report merely reflects the inventory of SBC's central offices. Different, and more accepted, financial reporting and audit methods are used for all other fiscal and regulatory matters. Since the transition to price-cap regulation, a central office inventory of this type is no longer significant in setting prices. In fact, the FCC itself has stated that under the price-cap system in place for the last eight years, actual investment has nothing to do with prices: a decline in physical plant investment does not trigger a change in the price-cap formula. What is more important to consumers is the productivity factor and Consumer Price Index rates the FCC uses to simulate competition: price cap regulation has reduced LEC prices annually and is calculated without regard to the inventory reflected in this audit report.

**Further, the impact of immaterial errors in any of the situations identified in the Audit Reports' Executive Summary would be non-existent or very minor.**[1] The significance of immaterial errors is unclear, given that the FCC's accounting and recordkeeping requirements have outlived their usefulness in accomplishing any of the original objectives they served under rate-of-return regulation, such as those listed in the Audit Reports' Executive Summary.

More specifically, the Audit Reports are seriously flawed in a number of respects, including without limitation the flaws discussed[2] in subsequent sections of this response:

1) **FCC auditors refused to consider evidence presented by the SBC LECs.** For example, after the field visits, the SBC LECs presented detailed information that clearly demonstrates the existence of more than 200 additional items auditors scored as "missing." The Audit Reports reflect that the FCC only re-scored 35 of these 200 items as "found." The Audit Reports fail to explain why the auditors refused to re-score the remaining items. FCC auditors also failed or refused to consider

[1] See Attachment C, "COE Records."

[2] The FCC Audits Branch provided copies of the December 22, 1998 draft audit reports to the SBC LECs. Because of the limited time and space to respond, this document is a response to the report and recommendations but does not constitute a comprehensive and final response to the findings, allegations and recommendations to that report.

evidence concerning items that had not yet been posted in PICS/DCPR or that were retirements in progress.

2) **In concluding that certain items were "seriously deficient," the Audit Reports applied an unwarranted and unprecedented interpretation of the FCC's property record requirements.** An item that is within the four walls of the central office should be found in compliance with the FCC's requirements. FCC rules do not require that any identification numbers appear on an item, or that the location be specified at the bay-and-shelf level. These examples suggest the Audit Reports' misinterpretation of the rules were designed to exaggerate the percentage of items the auditors describe as seriously deficient, or in apparent violation of the FCC's rules.

3) **The FCC auditors also refused to consider extensive evidence concerning the "undetailed investment" category – agreed to by the FCC thirty years ago – presented by the SBC LECs in their August 1998 comments** on the factual errors and omissions in the audit reports. The SBC LECs demonstrate that auditors have known about the undetailed investment since at least 1968. Until this audit, the FCC never took the position that the existence of the undetailed investment that pre-dated the mechanized property record system would violate FCC rules, or that the undetailed investment should be written off by a certain date. In fact, in a 1968 ruling, the FCC approved of the method used by the SBC LECs to create a mechanized property record system on a going-forward basis. This mechanization was a vast improvement compared to the manual records maintained prior to implementation of PICS/DCPR, and it enabled the carriers to make their CPRs much more readily accessible for examination by the FCC, greatly facilitating the audit process. The Audit Report ignores the FCC's prior knowledge and rulings and numerous filings regarding the undetailed investment.[3]

4) **The Audit Report disregards the significant impact that the Statewide Asset Validation and Retirement (SAVR) inventory process has had on the undetailed investment.** For example, as of year-end 1998, SWBT's undetailed investment had been reduced to just slightly over $100 million, from the $923.8 million amount at the time of the audited records

[3] Prior to divestiture in 1983, the FCC provided AT&T with approval to implement detailed record keeping on a "going forward basis" in the Bell System operating companies. As reflected in FCC rulings and several filings with the FCC, the FCC permitted detailing or elimination of the undetailed when it became feasible and practicable to do so. The SAVR process provides a procedure to systematically identify or eliminate the undetailed in a cost-effective manner.

in 1997.[4] SAVR inventories indicate, after careful examination, that about 97% of items listed in inventory records exist. Such dramatic progress in so short a time demonstrates the extraordinary effectiveness of the SAVR inventory process. During this inventory process, much of the undetailed investment has been detailed, already demonstrating its existence of more than $500 Million in investment at SWBT, as explained in letters to the FCC that the Audit Report simply ignored.

5) **There are significant defects in the statistical methods and audit procedures used by the FCC auditors.**[5] Even assuming the FCC's data is correct (which, the SBC LECs show, it is not), inappropriate sample design, lack of a two-way audit, and small sample size of central offices in each category, make it impossible for the Audit Reports to produce accurate results, especially those relating to the dollar value of investment. For this and other reasons, the Audit Reports' conclusion that the SBC LECs' investment is overstated by several hundred million dollars is highly questionable;[6] it would be inappropriate and ill-advised for the SBC LECs to make any adjustments to their books and records based on the Audit Reports.[7]

6) **Several problems with audit procedures caused biased results**, including, but not limited to, substitution of items, limitation of the population for convenience, and a significant amount of re-coding of many items to various degrees by the FCC audit teams.

**The SBC LECs reject any conclusions that the records and, therefore, Central Office Equipment accounts, may have been overstated for many years, and present substantial and credible evidence to support their position.** This statement in the Audit Report is pure conjecture: the FCC has no basis, statistical or otherwise, to make any conclusion regarding the duration of its alleged deficiencies.[8] Furthermore, the SAVR inventory process has, over the

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[4] For example, of the $7 billion in undetailed investment that was divided between SWBT and AT&T at divestiture (i.e., 1983) SWBT received received almost $6 billion, or over 85%, of those assets.
[5] See Attachment B, January 8, 1999 letter from Dr. Fritz Scheuren, Ernst & Young LLP to Ms. B. Jeannie Fry, SBC Communications Inc. (SBC).
[6] This conclusion also incorrectly assumes that a single number within a wide range is the "most likely value." (fn 32, Pacific Report and fn 33, SWBT Report) As noted in Attachment B, Page 2, of this response, values within an interval are statistically indistinguishable.
[7] See Attachment D, January 11, 1999 letter to SBC Telecommunications, Inc. from Ernst & Young, independent auditors.
[8] The Audit Report concludes the deficiencies in the companies' records are long-standing and unlikely to self-correct. The auditors base this conclusion on the nature and scope of the problem in the 1994 audit, and on a hypothetical argument that assumes deficiencies occurred uniformly

past 18 months, achieved the FCC's recommendation for a complete inventory of its Central Office Equipment. There is no need to repeat the same process, as the Audit Report recommends, since it is already underway at the Company's own initiative.

**Implementation of the SAVR inventory process and other recent improvements in procedures proves the SBC LEC's commitment to continuing compliance with FCC accounting and recordkeeping rules.** These audit requirements – outdated, unnecessary, or in dire need of drastic simplification and streamlining – force LECs to track network assets at an excessive level of detail, without regard to the materiality of individual items of very small value, and without providing commensurate benefits to consumers or regulators. The SBC LECs estimate they committed more than 30,000 person-hours and over $5 million simply to support FCC field visits and extensive data requests in the conduct of just this round of CPR audits. The FCC employed more than 30 people in the conduct of the audit of the SBC LECs, incurring such related expenses as travel and lodging during almost four weeks of field visits. Considering that these audits have no direct or particular impact on the public interest, SBC believes it and the government could better utilize those resources in assuring that new advanced network capabilities are deployed promptly so as to provide consumers with new and better services consistent with the Telecommunications Act of 1996.

**SBC LECs are substantially in compliance with the FCC's burdensome and unnecessary property record requirements.** Because of past, current, and ongoing voluntary compliance, the SBC LECs see no need to repeat in an inventory process as proposed in the Audit Report. Considering SBC LECs' voluntary SAVR inventory process, already completed or nearing completion, the Audit Report's recommendation of additional audits is wasteful and without regulatory or financial purpose.

**However, SBC remains concerned that no other telecommunications carriers must comply with the CPR inventory requirements.** SBC estimates it spends tens of millions of dollars annually to comply with USOA Part 32

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over the years. As Dr. Scheuren explains in Attachment B, the FCC engages in pure guesswork to support their hypothetical argument. The SBC LECs do not agree with most of what the FCC auditors considered to be "substantive deficiencies:" many were simply minor defects in the records that have no impact on the amount of investment. If one considered only the "not found" items and used a more accepted approach, the error rate per month or per year would be relatively low and insignificant, and in line with other businesses with similar inventory controls. Additionally, the 1994 audit was too limited to reach any reliable conclusions about the nature and scope of any deficiencies, especially given that the results of the inventories of judgmentally selected items during those audits were not disclosed and the companies were not given an opportunity to review or test the accuracy of those results.

regulations, of which the CPR audit is just a small part. The BOCs and GTE, and other local exchange providers, are the only telecommunications carriers that must still follow these archaic accounting procedures, despite the competition the SBC LECs face from carriers exempt from these rules.

**In summary, SBC LECs regret that dialogue between SBC and the FCC auditors has not yet resolved the many substantial and substantive differences that exist between the auditors and the audited. However, SBC LECs maintain and show that the Audit Reports:**

- **contain many uncorrected and unexplained factual inaccuracies, statistical flaws, and regulatory inconsistencies;**
- **imply a consumer impact that does not exist by preserving the audit of inventory balances made irrelevant by price cap regulation;**
- **ignore the SBC LEC's past, current, and ongoing compliance with wasteful and outdated regulations; and,**
- **perpetuate the inequitable application of CPR audit requirements in the telecommunications industry.**

## RESPONSE TO FCC'S RECOMMENDATIONS

### A. Adjustment to Central Office Equipment Accounts

**In light of these issues, there is no rational financial, regulatory, or statistical basis for the Audit Report's recommendations that SBC LECs should write off assets worth hundreds of millions of dollars by adjusting their Central Office Equipment accounts.** As part of the FCC's Audit Reports action, it recommends summarily writing-off $1,672.3 Million of SBC's central office hardwire investment This amount represents the FCC's estimate of the cost of hardwire investment "not found" for Pacific ($499.1Million) and for SWBT ($221.7Million) and undetailed investment of $27.7M for Pacific and $923.8M for SWBT. This recommendation has a number of serious flaws.

First, the recommended write-off is based on incorrect conclusions drawn from a seriously flawed audit methodology, statistical and non-statistical, as described earlier. These flaws serve to seriously exaggerate any so-called "missing" equipment and, consequently, the report cannot be used to support a write-off of this magnitude.

Second, the SAVR process (described below) in place at the SBC LECs is already correcting whatever problems might exist in the field. Through this process, items of equipment have either been retired or added back, as required.[9] Thus, a write-off of the recommended amounts would duplicate transactions that have already been made at Pacific and SWBT through a careful and methodical inventory process over the past 18 months. For example, SWBT has reduced its undetailed investment to just over $100 Million. Additionally, SWBT's analog SAVR process has proven the existence of most of the undetailed amount that the FCC would have SWBT write off. Thus, any required adjustment has already been made for the SBC LECs based upon an inventory process of its entire COE hardwire equipment.

Third, such a recommendation continues to demonstrate the FCC audit staff's refusal to recognize and its lack of understanding of the systems in place. Thus, the FCC apparently intends for the SBC LECs to adjust their ledgers now, but leave the CPRs unchanged until after the recommended inventory of all COE. The FCC does not state how we are to adjust our CPR by $1.7 Billion to match our general ledger adjustment. Making this adjustment will create a major out of balance situation between the detailed records (PICS/DCPR) and the general ledger, creating the very same type of situation for which the FCC faults the companies. Furthermore, the FCC rules and the PICS/DCPR do not provide for a percent of any item to be retired. Retirement dollars are and always have been tied to individual items within the detailed records. Making this adjustment would render our CPR useless as a method of detailing the dollar value of the assets on the ledger. Since the recommended write-off is not tied to individual assets, there would be no way to keep future accounting records tied to actual assets from this point forward.

Fourth, a write-off of the magnitude identified, based solely upon an audit sample, represents drastic, punitive and inappropriate corrective action. The FCC's recommendation is to make the write-off, then perform a complete inventory and then make reconciling adjustments as necessitated by the inventory. The more appropriate approach would be to use the sample audit results to justify performing a complete inventory. As the inventory is conducted, adjustments to the books and records necessitated by not found conditions, etc. would be made on a continuous basis as appropriate. In this way the books and records are adjusted once, correctly rather than based on inaccurate estimates that contain biases and cannot be fairly relied upon. The more appropriate approach is the one used in the company's SAVR process. The SBC LECs have

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[9] As of the date of this January 11, 1999 report, Pacific has retired more than $300 Million and added almost $100 Million in hardwire central office equipment and SWBT has retired approximately $200 Million and added back almost $100 Million as a result of the SAVR inventory and CPR reconciliation process. Retirements associated with the SAVR process have been treated like any other retirement recorded in the companies' books and records. Future retirements from SAVR, or other similar audit, should be treated in the same fashion, resulting from a systematic inventory process.

already undertaken logical steps toward compliance by performing a 100% physical inventory by central office to determine which units should be retired.

Fifth, it would be improper for the FCC to require a write-off of this nature without a fair evaluation of all the circumstances in a hearing on the merits after full and complete discovery.[10]

As the Audit Reports themselves acknowledge, "the only way to ensure a CPR line-item is correct is to examine the corresponding equipment items. The only way to validate all of the line-items is to conduct an inventory of the entire CPR."[11] The Audit Reports contradict this reasoning when they propose that the companies summarily eliminate almost $1.7 Billion from their regulated ledgers without consideration of the impact on the CPR. For all the above reasons, this is not a proper course of action.

**B. Engage an independent firm to provide an inventory of the entire central office**

**In light of the SAVR inventory process, voluntarily undertaken at the SBC LECs, there is no rational financial, regulatory, or statistical basis for the Audit Report's recommendations to engage an independent firm to inventory the SBC LEC's entire central office physical plant. However, the SBC LECs invite the FCC to review its SAVR inventory process.** The recommendation contained in FCC's reports to engage an independent firm to provide an inventory of its entire COE would certainly produce a significantly different number than that estimated by the FCC. The FCC suggests that the results of such an audit should be the basis for the CPR adjustment. The SBC LECs agree. Those results, and only those results, should be the basis of any adjustment to the CPR as well as any overall adjustment to the ledger balances.

However, this work is already in progress with the 1997 implementation of the SAVR process. The SBC LECs have enlisted independent contractors to perform the central office physical inventories.[12] The physical central office inventories included providing reports of equipment to be retired/reclassified or

[10] Additionally, the write-off recommendation for Pacific does not indicate what portion of the "write-off" should be taken by Nevada Bell and by Pacific Bell, even though these two companies operate and are regulated as completely separate entities.
[11] Audit Report for Pacific, Page 15, ¶38.
[12] Pacific Bell and SWBT hired contractors to perform the physical inventory services associated with the SAVR process. While Pacific Bell and SWBT employees did not perform the physical inventories associated with the SAVR process, employees were used to perform the reconciliation and input of equipment adds into the PICS/DCPR database. The expense for outside contractors for the SAVR program has exceeded $1 Million.

added to the CPR record. The SBC LECs have also on several occasions provided SAVR Methods and Procedures to the FCC and have voluntarily invited the FCC to review/audit the SAVR process, including review of all cost substantiation data and physical inventory reports (deletes, adds and reclassifications). The FCC has declined participation or even observation of the SAVR inventory and reconciliation process at the SBC LECs.[13]

Upon the completion of the SAVR inventory and reconciliation process, an inventory of 100% of the hardwire assets will be complete.[14]

**C. Engage an independent audit firm to perform a review of the controls and systems in place for its continuing property records.**

**The Commission recommends engaging an independent auditor to review Pacific's and SWBT's practices, procedures and controls for maintaining CPR and to make recommendations for improving those systems. To the extent that such a review may be warranted based upon sample findings (i.e., of the SAVR inventory process), SBC would support such a review performed by its independent external auditors who are already familiar with the companies' systems.**

Although technology has changed dramatically since 1968, when the PICS/DCPR system was first implemented, the FCC accounting and record keeping requirements have not kept pace with this change. For example, the SBC LECs have progressed into ordering equipment in modules not individual piece parts. In elevating the level at which we keep track of hardwired equipment we will be able to enhance asset tracking capabilities. While we agree and have discussed strategies around benchmarking and development of a new more user

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[13] Instead of reviewing the SAVR inventory process, the FCC audit staff dismisses the results of the SAVR process because "the carrier's subsequent claim to reduce the Undetailed Investment balance was not accompanied by documentation." Audit Report for SWBT, fn 39. As explained above, the SBC LECs offered to show the FCC's staff how the SAVR process is performing an manner to reduce the undetailed investment. The FCC staff has had every opportunity to perform an evaluation of this process.

[14] To explain, to prioritize its work, Pacific Bell will complete its 100% SAVR inventories in the 1 Q of 1999. Work plans are already underway to initiate the process at Nevada Bell in 1999. At SWBT, a threshold of $10 Million (for digital central offices) was established to prioritize the inventory process. This inventory will complete in 3 Q 1999 and work is already in progress at SWBT to schedule the inventory of the remaining central offices at SWBT of those with less than $10 Million of investment. SWBT completed its work, ahead of schedule, in 4th Q 1998 to inventory 100% of its analog central offices. In addition, the SBC LECs have been working with Ernst/Young LLP since the Fall of 1998 to develop and implement a process called "SAVR II." SAVR II is an on-going central office sampling that will be compared to the actual detailed record. Error thresholds will be developed, and all offices not in compliance will be inventoried 100%.

friendly asset management system we also feel strongly that the FCC should work as our partners in the development of new FCC record keeping guidelines that are more consistent with the current times and technology.

**The SBC LECs can enlist an independent auditor review of the Pacific and Southwestern Bell Telephone Company practices, procedures, and controls for maintaining CPR and will request the independent auditor to provide recommendations on asset tracking to the FCC. In addition** to asking its independent auditor to review the companies' practices, procedures and controls, **the SBC LECs also propose to request that the independent auditor review the FCC's CPR requirements and make recommendations to the FCC to update and streamline its plant tracking requirements** to make them less burdensome and more meaningful in light of the current technology and competitive environment.

## II. THE FCC'S STATISTICAL DESIGN HAS SIGNIFICANT DEFECTS, BOTH STATISTICAL AND NON-STATISTICAL MAKING THE RESULTS UNSOUND AND UNRELIABLE. THEREFORE, STATEMENTS IN THE REPORT REGARDING PER CENT COMPLIANCE OR DOLLAR VALUE OF INVESTMENT ARE INACCURATE AND UNJUSTIFIABLE.

### A. STATISTICAL ERRORS:

The FCC's report presents extensive details concerning the sampling design and the way the sampling was performed by the FCC. However, despite the lengthy discussion by the FCC, including the statements in Appendix B regarding the benefits of random stratified sampling, the information presented in the report demonstrates that the FCC did not perform the type of sampling it says that it set out to do.[15]

In addition, while there are always operational problems that need to be overcome in an audit, an audit process should have specific rules for handling contingencies. If each audit team is left too much latitude in judging how to handle problems, then audit results will not be consistent across audit teams. Furthermore, the procedures that are used to carry out the audit process need to account for assumptions about randomness that are a part of the sample design.

A sample design is created in order to control the amount of error in statistical estimates due to random or sampling error. A good audit plan is much more than a good sample design. The audit plan must employ an extensive set of procedural operations to reduce the various forms of non-sampling error so that they do not materially impact the audit objectives. The FCC's process did not accomplish this, as noted below.

First of all, the data collection procedures used by the FCC introduced a significant amount of non-randomness into the sample selected. For example:

- The FCC's audit contained procedural inadequacies and ad hoc decisions that illustrate a lack of control over the audit teams and which, in themselves, can introduce bias. At the very least, audit results can no longer be applied to the entire population, since the sample is no longer representative of that population. For example, the auditors sometimes substituted items, on-site,

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[15] The analysis for statistical errors is an extremely complex process that takes considerable time and expertise. Thus, in view of recent changes in the FCC's data not provided to the FCC LECs until January 7, 1999, SBC has not completed its statistical review and may have further errors to identify.

for other than those that were originally sampled when the auditors judged an item too hard to get to (e.g., located immediately outside the central office in a manhole). [16] On the other hand, there were similar situations[17] for which the FCC auditors did not substitute replacement items or take the trouble to go and inspect, yet the auditors graded them as "not found."

- The locations selected for SWBT and for Pacific appear in some instances limited for convenience. The FCC reports[18] that some locations were "impractical to audit" and, consequently, "another location was randomly selected."[19] This means that records (and all those of similar locations) that were deemed impractical need to be removed from the scope of the study. If records were ineligible for inclusion in the sample, then it is inappropriate to try to apply the results based on the sample using these items.

- The FCC created a class of items that was not eligible for sampling. The FCC's report states that "when we determined that verification of a selected item would not be possible for reasons beyond the control of the company, we selected the CPR item immediately preceding the selected item as its replacement."[20] The net effect of this practice is to create a sample for which there is no way to determine the correct weighting necessary to develop final results. The sample consists of records with varying probabilities of selection, probabilities that have not been used by the FCC in making their estimates.

In summary, in all three of the above instances, records that cannot be verified for reasons beyond the control of the company need to be identified and removed from the universe of records. These records represent a separate class of items that might have substantially different error rates. Without removing

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[16] For example, on the day of the auditors' field visit to the central office in Weldon Springs, Missouri, the auditors substituted two different items for two "repeater cases." Since "repeater cases" are equipment physically located outside and away from the central office or in manholes, the auditors replaced these two items. One was replaced with a test unit and the other with a shelf and both of these items were graded as "found" by the auditors. (See HVTRMO65, items no. 1 and 2.)

[17] In Clint, Texas on the day of the FCC's field visit, the auditors were looking for five plug-ins or circuit packs. SWBT personnel advised the auditors that the items were located in the Canutillo central office ("CLNTLTXMA") instead of the Clint central office ("CLNTTXMA"). Since the Canutillo office was located less than 1 hour away, SWBT personnel offered to take the auditors to the Canutillo office to verify the plug in units. The auditors declined to visit the other location and did not provide replacement items for verification. On December 17, 1997, as a follow up, SWBT formally requested that the FCC exclude these five items from the audit sample.

[18] See Pacific Report, Appendix B at Page 7.

[19] The Audit Reports do not indicate what method of random selection was used to pick the substituted location(s).

[20] See Pacific and SWBT Draft Report, Appendix B at Page 6, Footnote 17.

such items, the FCC's sampling process introduces bias into the audit's results, overstating the total dollar value of line items in error.

Next, there are errors in the FCC's calculations.[21] The margin of error for missing property investment suggested in the audit report is understated. The larger the margin of error, the less reliable the results. The formula employed in the report assumes that the sample is large enough to apply a standard (normal) distribution approximation (the "bell-shaped" curve from any introductory statistical text) to obtain confidence intervals. This assumption is in error. The sample size used in the audit is not large enough to use the normal approximation. This leads the audit report to systematically understate the margin of error in the associated dollar estimates. As a result, the errors created by the FCC in its data collection and sample design result in a much wider margin of error than that discussed by the FCC in the report. In addition, the report does not include credit for certain additional items. Thus, rather than a lower limit of $216.5 Million for Pacific and $105.3 Million for SWBT, the lower limit may very likely be at or well <u>below</u> $0.[22]

Given this level of imprecision, it would also be unsound for the FCC to give much weight to any conclusions in its report regarding the dollar values of records for which no equipment was found. The reports also mention that the true value of understated investment is "most likely"[23] centered around the midpoint of the interval. This statement is plain wrong; it cannot be statistically supported. Confidence intervals give a measure of the precision of the estimate, but no value contained within the interval is necessarily "better" than any other. In a sense, values within an interval are statistically indistinguishable. Thus, a

[21] As explained by Dr. Scheuren, in Attachment B to this reply, the Bayesian analysis added to the latest draft of the FCC's audit reports does not eliminate the bias and other problems in the FCC's initial analysis. Thus, the problems with the sample design and the margin of error also cause the Bayesian results to be inaccurate and unreliable.

[22] Even at face value, FCC's resulting range (i.e., ±40-50%) for the dollar value already is extremely broad and imprecise. The FCC's report states (on Page 9 of the December 22, 1998 Pacific report) that it estimated that the total missing plant cost lies between $282.6 and $715.6 Million. If correct, using the FCC's $499.1 midpoint, as presented by the FCC's report, results in $216.5 Million or more than a ±40% error in either direction. Similarly, the FCC's report states (on Page 10 of the December 22, 1998 report for SWBT) that it estimated that the total missing plant cost lies between $105.3 and $338.1 Million. If correct, using the $221.7 midpoint, as stated in the FCC's report, results in $116.4 Million or greater than a ±50% error in either direction. By the report's own admission, this means that there is a huge margin of error in the FCC's estimate in the resulting dollar value for both SWBT and Pacific!

[23] See Draft Pacific Report at Page 10 Footnote 32 and SWBT Draft Reports at Page 10, Footnote 33

proper conservative[24] approach would be to use the lower bound of the interval as the cost of the missing property. And, as noted, above, the lower bound could be <u>at or near $0</u>.

<u>B. NON-STATISTICAL</u>

In addition, as noted below, the FCC did not design its audit process to ultimately arrive at a dollar value. Thus, the reports' statements regarding dollar value of investment are in error.

The sample design was intended to measure the *proportion of items* not found. It was not intended to measure the *dollar value* of missing items. Had the intent been to make such an inference (regarding the accuracy of investment), the sample should have been designed differently. The audit reports' effort to make statements about dollar values is highly questionable, and subject to significant potential uncertainty, with the small sample of central office locations actually visited.

In addition, in the actual audit process, as noted in the reports, the FCC only performed a "one-way" audit. That is, no procedures were put into place to perform a search for items that might exist at a central office, but might be missing from the CPR records. This procedure is required in order to make any calculations or conclusions regarding a "dollar value" of investment. The failure to conduct a reverse or two-way audit[25] means that any quantification of "missing" investment systematically overstates any value and cannot be relied upon. The FCC's audit can only speak to potential deficiencies in the CPR storage system, not to whether or not the investment levels are properly stated on the company books.[26]

In fact, in 1997 and 1998, Pacific and Nevada voluntarily have undertaken the task of performing a complete inventory of all central offices (the SAVR project)

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[24] See attached January 8, 1999 letter to SBC Communications Inc. from Dr. Fritz Scheuren, Ph.D., National Technical Director for Statistical Sampling, Ernst and Young LLP. See also, "Statistical Models and Analysis in Auditing," *Statistical Science, 1989, v.4, no. 1, pp. 10-11.*

[25] A two-way audit would also include an inventory of randomly selected offices and a check to see if items found in the inventory can be tied back to the property records. The only way to determine "missing" equipment would be to take the results of the initial audit and net them against the results of the reverse direction audit.

[26] For example, in SWBT's December 16, 1998 letter to Mr. Ken Moran of the FCC regarding the analog SAVR process, SWBT noted that it had identified and "reverse retired" (i.e., put back onto the company's books) more than $47 Million in hardwire investment. See also, description of SAVR inventory process on the following pages in this response to the audit report. In contrast to the FCC's one-way audit process, the SAVR process represents a "complete" two-way audit process.

and SWBT has voluntarily undertaken the same SAVR inventory of 100% of the analog central offices and all central offices having greater than $10 Million in investment. Given the SAVR project, the FCC should have proceeded differently with its audit. It should have concurred with the companies in the SAVR audit approach, checked its implementation, and then approved what the SBC LECs are doing instead of erroneously extrapolating some gross amount. The SBC LECs have, on more than one occasion, invited the FCC to perform such a review and they have declined to initiate any such review. Through such a review of the SAVR process, the FCC would know what property should be added or removed from the companies records.

In addition to the inherent limitations in the FCC's audit process and statistical design, the audit teams themselves had an effect upon the results. There were numerous inconsistencies in the way items were originally coded for compliance across inspection teams and significant differences in the number of corrections made by different audit teams. At many locations, the two auditors each inspected half of the items, then got together and revised their grades. Subsequently, the codes were revised yet again back at the FCC offices. This resulted in a re-coding of over 12% of the items across all audit teams. One of the audit teams had over 45% of its original codes revised.[27] This indicates little or no pre-audit training and/or a lack of consistency of any written guidelines over such things as how to code the property records. This also indicates that the standards of review were ill-defined or not defined at all in advance; instead, the standards were developed as the audit proceeded to yield the most exaggerated (albeit erroneous) statements of deficiencies. Finally, contrary to sound statistical methodology, the FCC relied on the written notes of auditors rather than making second visits of a sub-sample of locations. And, despite the re-coding of items back at the FCC office, some items still remained inconsistently coded under like circumstances.[28] The point is that if there are errors or inconsistencies in the FCC's scoring, how can one be assured that all were identified and corrected?

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[27] See Attachment A to this January 11, 1999 reply. These changes or rescorings were not based on additional information or revisits.

[28] See SWBT January 29, 1998 reply to FCC. At the Hot Springs, Arkansas central office (item no. 6, HTSPARLADSO), the auditors graded a test trunk unit as unverified because the number could not be seen. However, as noted in the information provided to the FCC, the same equipment was reviewed in three other central offices and the results are graded as "found." See also, Pacific January 29, 1998 reply to the FCC. At the Palo Alto central office (item no. 3, PLALCA12), the auditors graded the fiber optic bay as unverified because a number could not be found on the equipment. However, as noted in the information provided to the FCC, the vendor does not stencil the number on the equipment; and, this same equipment was graded as "found" in other locations.

The audit process itself needs to have rigidly defined rules that leave no doubt on how each item is to be classified. The report fails to include a copy of any written guidelines distributed to the auditors prior to their field work. Such guidelines would ensure consistency in evaluating the equipment. Instead, the audit report states that auditors' "CPR inventory forms, including the comment section, were reviewed by the audit supervisor and were revised as necessary for consistency with the audit criteria." [29] Reclassification of field work, after the fact, is highly suspicious and invariably leads to questionable results.

## C. IMPLICATIONS FOR STATES:

The FCC's audit plan and conclusions are not applicable to any state jurisdiction. In order for the audit to have any application or usefulness for any state jurisdiction, the audit should have been designed differently. If the FCC wanted to have all states represented, then the wrong approach was used. Instead of taking the FCC's approach, a state stratification should have been done. The whole CLLI sample size would then have been allocated according to a two-way stratification (by state and with the original strata). Just as with the single stratification, every stratum would need at least two CLLIs allocated to it. A minimum of two CLLIs are needed to calculate any variance. More than this minimum may be needed to obtain adequate precision for a particular state. Since that was not done, the FCC will not be able to produce precise estimates at the state level, even though they noted in the report that every state was represented in the sample. The sample that the FCC has drawn is not representative by state.

For example, the report for SWBT states that the items selected "were expected to be representative of the entire SWBT operating area covering the states of Arkansas, Kansas, Missouri, Oklahoma, and Texas."[30] However, the report fails to mention that, of the many central offices located in Oklahoma, only one small central office[31] was selected for review in that state.

And, the report for Pacific states that for "purposes of this report, Pacific Bell and Nevada Bell are referred to as 'Pacific.'"[32] These companies operate as separate entities and it is misleading to combine the results for these two companies together. Moreover, the report fails to mention that only one central office was

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[29] See Pacific and SWBT Reports at Appendix B, Page 8.
[30] See SWBT Report at Page 8.
[31] Within the State of Oklahoma, only the one central office in McAlester, Oklahoma was selected for review by the FCC.
[32] See Pacific Report at Page 1.

selected for review at Nevada Bell.[33] How can the FCC justify a multi-million dollar adjustment to Nevada's books and records based upon two or three items that the FCC says it could not find in one central office? It would be totally inappropriate to draw statewide conclusions based on a sample of only two or three items found in one central office.

* * * * * * *

The result of the defects in the FCC's statistical sampling process and audit process itself is that (1) resulting precision levels were not as planned; (2) inclusion of statements regarding investment are in error and should be omitted from the report; and (3) conclusions regarding per cent compliance are in error in the FCC's report. Finally, the SBC LECs take serious exception to the reports' characterization that the records may have been overstated for many years. This statement in the FCC report is purely conjecture and, clearly, the FCC has no basis, statistical or otherwise, for any conclusion regarding the duration of the problem.[34] Finally, our external auditors explain that it would be inappropriate for Pacific Bell, Nevada Bell, and Southwestern Bell Telephone Companies to make any financial adjustments based on the FCC's audit reports.[35]

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[33] Only the Sparks central office in Sparks, Nevada was selected by the FCC for its review of Nevada Bell and only one item in that office was considered "not found" by the FCC.
[34] See Attachment B to this January 11, 1998 reply: Letter from Dr. Fritz Scheuren, Ph.D., National Technical Director for Statistical Sampling, Ernst and Young LLP.
[35] See Attachment D to this reply. Ernst & Young serves as the Independent Auditor for SBC Communications Inc. and its telephone company subsidiaries.

## III. THE FCC'S CONCLUSION REGARDING THE OVERSTATEMENT OF THE COMPANY'S INVESTMENT IS HIGHLY QUESTIONABLE .

A. UNDETAILED INVESTMENT: Reports to the FCC regarding the Statewide Asset Verification & Retirement (SAVR) project have demonstrated that a significant amount of the undetailed investment on the company's books does exist. Thus, the FCC is in error to conclude that none of the undetailed (CPR #040000) exists or ever existed contrary to the additional information provided to the FCC by Pacific and SWBT.[36]

To explain, the Statewide Asset Validation and Retirement (SAVR) project was first developed by Pacific Bell in late 1996 and implemented in early 1997 to perform physical inventories of 100% of the central offices at Pacific Bell. Following the merger, Southwestern Bell Telephone Company (SWBT) adopted the SAVR project in mid-1997and initiated the physical inventory process in the 3rd Quarter of 1997.

Both companies have provided extensive information to the FCC regarding the "undetailed" investment. Most significantly, the SBC LECs have repeatedly asked the FCC to review the SAVR process audit and inventory process. Pacific and SWBT have explained to the FCC that the SAVR inventory process *includes* the following procedures: (1) equipment on the company records that is not found is retired, (2) equipment not on the company records that is found is put onto the books or "reverse retired" and (3) found equipment that was formerly categorized as "undetailed" is identified and "detailed" (i.e., changed to show a specific description and location) in the company's records.

[36] Page 2 of Pacific's Report states that the FCC found more than $27 Million in undetailed investment. Page 2 of SWBT's Report states that the FCC found $923.8 Million in undetailed investment. These amounts are the balances for the undetailed investment as provided to the FCC in response to its data requests of June 27, 1997 (balances as of July 10, 1997 for Pacific) and April 15, 1997 (balances as of July 22, 1997 for SWBT).

This SAVR physical inventory process, voluntarily initiated by Pacific and SWBT, demonstrates that a significant amount of the undetailed investment does exist in the central offices. An example of the type of information already voluntarily provided on a regular basis to the FCC is as follows:

Information Provided to the FCC:[37]

| | |
|---|---|
| Southwestern Bell (through November 30, 1998) | |
| Starting Balance Undetailed (1/1/98) | $ 826.6 Million |
| Equipment Retired | $174.0 Million |
| Equipment Specifically Identified (i.e., “Detailed”) | $445.4 Million |
| Ending Balance Undetailed (11/30/98) | $ 207.3 Million |

The FCC has not considered at all the fact that the majority of the undetailed investment actually exists, as evidenced by the “undetailed” investment found and in service as part of SWBT’s analog SAVR inventory process. Therefore, the FCC’s conclusion (SWBT Audit Report, page 15) is in error when it states that SWBT’s plant balance is overstated by a July 1997 amount of $923.8 Million “that could not be substantiated.”[38] This information is obviously wrong given the SAVR project results.

In addition, the FCC’s report implies that this amount has remained fixed when the information provided to the FCC is to the contrary. As the FCC is aware, the November 30, 1998 balance of $207 Million in undetailed investment represented *more than* an 85% reduction from $1.5 Billion in undetailed in 1994.[39] The year-end 1998 balance of slightly more than $100 Million shows that SWBT is within

[37] See letters dated July 1, 1998 ,May 22, 1998, September 25, 1998 and December 16, 1998 from Ms. B. Jeannie Fry, SBC Communications Inc. to Mr. Ken Moran, Chief, Accounting Safeguards Division, FCC.

[38] In fact, the Audit Report reflects a bias against SWBT with respect to the undetailed investment. For example, the December 22, 1998 audit report focuses on extremely old vintages of what it calls “unspecified investment,” which includes undetailed equipment, as well as other categories, instead of providing a fair, balanced and complete description of the nature of the undetailed investment. (See SWBT’s Audit Report, Appendix A at p.2.) Instead of focusing its description on extremely old entries, the Audit Report should adequately describe the composition of the undetailed investment as a stand alone category. For example, as SWBT’s April 7, 1997 response to the FCC’s March 20, 1997 data request shows, the bulk of the undetailed investment represents equipment placed in service between 1966 and 1982. In addition, SWBT’s April 7, 1997 response lists “1941” as the oldest year of undetailed investment. Furthermore, the information in Appendix A, page 2, Footnote 2 of the FCC’s draft report regarding “1900” and “1905” equipment is not supported. Thus, by combining all of the types of unspecified equipment together, without the details, the report misleads users of the information concerning the bulk of the “unspecified investment.”

[39] For 1994 and 1995 data, see May 22, 1995 letter from SWBT’s Ms. Jane Knox to FCC’s Mr. Jose Rodriguez.

arm's reach of its goal of reducing the undetailed category of investment to a level of only limited on-going use. In addition, the SAVR reconciliation and inventory process has identified, reclassified and added back almost $100 Million in hardwire central office investment as of December 31, 1998 at SWBT.

COMPARISON OF SWBT'S UNDETAILED INVESTMENT

| *Balance as of:* | *$ BILLIONS* | *Cumulative % Change* |
|---|---|---|
| May, 1994 | $1.470 | |
| May, 1995 | $1.328 | |
| May 1998 | $ .784 | |
| November, 1998 | $ .207 | -85% |
| January 1, 1999 | $.119 | -92% |

A fair and balanced description of the prudent and methodical process to identify and reduce the undetailed by SWBT has been omitted from the FCC's report and recommendations.

Finally, as noted below, prior to divestiture in 1983, the FCC provided AT&T with approval to implement detailed record keeping on a "going forward basis" in the Bell System operating companies. [40] As reflected in FCC rulings and several filings with the FCC, the FCC permitted detailing or elimination of the undetailed investment when it became feasible and practicable to do so. The SAVR process provides a procedure to systematically identify or eliminate the undetailed investment in a cost effective manner.

B. THE FCC FAILS TO CONSIDER ITEMS THAT WERE PRESENT IN A LOCATION BUT NOT YET POSTED TO THE COMPANY'S PROPERTY RECORDS.

The FCC designed and performed an audit process by which it *only* looked for items listed on the company's records. However, it did not allow for and should have provided for the existence of items in central office locations that might not have posted to the engineering record system (PICS/DCPR). By contrast, the companies' SAVR inventory process provides for a "two-way" audit of the central office. The information provided to the FCC, regarding the benefits of the SAVR process, demonstrates that it is an error to include conclusions about any misstatement regarding investment amounts on the company's books without also netting the effect of the existence of items in the central office which may be

[40] See December 24, 1968 letter to Mr. Alexander Stott, Vice President & Comptroller, AT&T from Kelley E. Griffith, Chief, Common Carrier Bureau.

in the process of being posted to the engineering records or which may have never been posted to the engineering records in detail.

The FCC's report draws its conclusions without the inclusion of information presented by Pacific and SWBT that clearly demonstrates the existence of items in the central office locations that has not yet been posted to the engineering record system. For example, on May 4, 1998, Pacific Bell noted in its response to the FCC's data request that it had identified and "reverse retired" an additional $1.3 Million in equipment from January 1, 1997 through February 28, 1998 as the result of the SAVR process alone. In addition, as of November 30, 1998, through this process SWBT has identified an additional $47 Million[41] in equipment that existed and was in-service and working but not listed on the records and, therefore, SWBT added this equipment to its records (i.e., "reverse retired"). This information is significant and the auditors should have considered this kind of event in their analysis, planned for it in their audit process and included it in their audit report.

<u>C. THE FCC HAS FAILED TO INCLUDE EVIDENCE PRESENTED THAT ITEMS GRADED BY THE FCC AS "NOT FOUND" WERE IN THE PROCESS OF BEING RETIRED AT THE TIME OF THE AUDIT</u>

Some of the items counted by the FCC as "not found" were not present at the time of the field visits for the audit because they had been retired from service prior to the FCC's field visits but after the records were provided to the FCC[42] for their use to perform its audit.

Although the amount of time the FCC thinks is reasonable to remove an item from , or add equipment to, the company's records is not precisely defined in its rules, [43] clearly, its rules do recognize that there is a process required to take equipment from service and remove the equipment and its investment from the company's records.

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[41] The $6.2 Million for Pacific Bell represents $1.8 Million in analog equipment, $3.0 Million in digital equipment and $1.4 Million in operator services equipment. This information is for SWBT as of November 30, 1998 and was provided to the FCC on December 16, 1998.

[42] See July 25, 1997 SWBT reply to FCC's April 14, 1997 data request and August 6, 1997 Pacific reply to FCC's June 27, 1997 data request for copies of the companies' continuing property records.

[43] 32.2000 (d) (ii) also states, "Literal compliance with the provision for timing of entries with respect to property amounting to less than $50,000 retired under any one project is not required if an unreasonable amount of record keeping and estimating of quantities, original cost and salvage is necessary." A parallel provision appeared previously in Part 31: 47 C.F.R. Part 31, Appendix B (1986), ¶2(d), which stated in part as follows: "Property changes…shall be promptly processed in the continuing property record to the end that the record shall provide <u>reasonably</u> current data at all times."(emphasis added.)

Pacific submitted information regarding 22 items and SWBT submitted information regarding 16 items for the FCC's review that were retirements in progress.[44] The FCC's reports fail to explain why it refuses to rescore such items that were in the process of being retired. From the reports, it appears that none of the Pacific items were re-scored and, in addition, the FCC has failed to explain why all 16 items submitted by SWBT cannot be re-scored.[45] This is an error in the application of the FCC's rules and incorrectly counts items that should not be considered deficient.

## <u>D. THE FCC HAS FAILED TO INCLUDE EVIDENCE PRESENTED DURING AND AFTER THE FIELD VISITS THAT CLEARLY DEMONSTRATES THAT ITEMS WERE PRESENT AND EXISTED AT THE TIME OF THE AUDIT</u>

The FCC completed its field visits in September, 1997. Following receipt of the FCC's preliminary results two months later, in November of 1997, Pacific and SWBT began to diligently research the results presented in order to provide additional supporting evidence.

In many cases, at the time of the field visits, the FCC's auditors were shown the equipment, but refused to accept what they were being shown. In some cases, the FCC sought additional information to support the equipment's existence.[46] In any event, because the FCC scored the item as "not found" or "unverifiable," SBC personnel spent *thousands of* person hours researching the items, copying invoices, engineering drawings, etc. and summarizing this type of information in written narrative form to provide additional supporting information to the FCC. When the auditors provided their preliminary results in November of 1997, they requested any additional information that would change the results for items that the auditors had scored as "not found" or "unverifiable." And yet, even though the auditors requested this information, which SWBT and Pacific submitted in

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[44] SWBT and Pacific define "retirements in progress" as the period of time between the time the equipment is removed from providing service until all of the paperwork has been completely processed to remove the equipment and its investment from the books and records of the company.

[45] The December 22, 1998 draft reports provided to the SBC LECs on December 23, 1998 did not include any definitive information on items rescored. This information was subsequently provided to the SBC LECs on January 7, 1999; however, due to the limited time provided for this response, the SBC LECs are unable to provide a more comprehensive analysis in this reply.

[46] In some cases, the item was an embedded component of the equipment. Also, due to the complexity of the technology of today's central offices, there were other instances where company personnel could not locate an item within the short time allowed for each of the 36 items during a four to eight hour field visit to the central office but subsequently company personnel <u>did</u> locate the equipment. Finally, there were instances where a manufacturer's part number was not visible and the FCC sought additional information to verify the item.

numerous detailed "write ups," the audit report has omitted or rejected this information without explanation[47], which it should have considered, and the auditors have refused to re-score the items.

As a result of the audit reports' erroneous rejection of the numerous "write-ups" submitted by SWBT and Pacific, many of the numbers in the audit reports are in error by a significant margin. In addition, in connection with the SAVR inventories of all the hardwire equipment in a number of central offices, the SBC LECs have found a much higher percentage of items than the FCC's auditors, as shown in the following comparison between the SAVR results and the FCC's results:

| COMPANY | *Per Cent Items "Found" by SAVR* | *Per Cent Items "Found" by FCC* |
|---|---|---|
| Pacific | > 97.5% | >82% |
| SWBT | >97.5% | >78% |

Pacific and SWBT both have submitted detailed information that clearly demonstrates the existence of more than <u>200</u> additional items. Of those submitted, the FCC's report reflects that they have rescored <u>only</u> <u>11</u> items as "found" for Pacific and <u>only 24</u> items as "found" for SWBT. The audit report fails to include the more detailed information provided to the FCC over a period of more than eight months in more than 21 supplemental replies for Pacific and more than 16 supplemental replies for SWBT.[48] The audit report improperly rejects, without adequate explanation, the numerous documents submitted by the SBC LECs to substantiate, the existence of most of the items that the Audit Report claims could not be verified. Thus, the audit reports fail to present an accurate, fair and unbiased report.

In short, the audit report is in error and is contrary to the evidence presented because:

[47] See replies provided to the FCC for Pacific Bell as follows: November 21, 1997, December 17, 1997, January 16, 1998, January 29, 1998, February 20, 1998, February 27, 1998, March 6, 1998, March 10, 1998, March 11, 1998, March 12, 1998, March 13, 1998, March 16, 1998, March 17, 1998, March 24, 1998, March 26, 1998, March 27, 1998, April 16. 1998, May 19, 1998, May 22, 1998, June 8, 1998, June 17, 1998 and June 23, 1998. See replies for SWBT provided to the FCC as follows: November 21, 1997, December 17, 1997, January 16, 1998, January 29, 1998, March 6, 1998, March 10, 1998, March 11, 1998, March 12, 1998, March 26, 1998, March 27, 1998, April 17, 1998, May 7, 1998, May 26, 1998, May 27, 1998, June 8, 1998, June 16, 1998 and June 23, 1998.

[48] Additionally, the December 22, 1998 reports do not explain the FCC's rationale or standards of review used to change the scoring of items reported in the July 20, 1998 draft report.

1. The audit report improperly rejects the evidence of the existence of items presented in more than 200 write ups covering individual as well as multiple items;
2. It fails to explain the auditors' reasons for rejecting each of the more than 165 items for which the auditors would not change their results;
3. It fails to describe the auditors' standard of review or standard of proof applied to decide how to grade each of the write ups; and
4. It fails to explain the auditors' reason(s) for neither (a) seeking additional information from SWBT or Pacific nor (b) going back to the locations to verify results on disputed items.
5. It fails to provide support for sound and reliable auditing procedures and statistical procedures.

E. THE FCC HAS FAILED TO INCLUDE EVIDENCE THAT ITEMS WERE PRESENT AND EXISTED AT THE TIME OF THE AUDIT, ALTHOUGH LOCATED IN ANOTHER LOCATION WITHIN THE FOUR WALLS OF THE CENTRAL OFFICE

The two reports fail to adequately provide SWBT and Pacific "credit" for items found in other locations although they were "readily spot-checked" and shown to the auditor and found to exist within the four walls of the central office.

The grading as described by the FCC to Pacific and to SWBT throughout the first 12 months of the audit and provided to the SBC LECs in November 1997 was as follows[49]:

1 = Found
2 = Found – Other Location
3 = Not Found
4 = Unverifiable

However, the FCC- has changed its grading system as reported on page 7 of each of the two audit reports. The new categories of information are "Found," "Partially Found," "No Assets Found" and "Unverifiable." With this new grading system, the FCC audit report has rescored the "Found-Other Locations" ("2's") as "Unverifiable" ("4's").

The "Found-Other Locations" were not unverifiable; as noted on page 7 of both reports, by the reports' own admission, the "auditors were often taken to other locations in the office and shown items on different frames [locations] than those listed in the CPR." These items obviously were found and did exist in the proper quantity within the four walls of the central office location at the time of the field visit. It is unfair and incorrect for the audit report to count these records as "unverifiable" since these assets were able to be "readily spot checked" and were "found." Further, the reports mischaracterize the auditors' preliminary findings by changing the grading after the fact.

## F. THE FCC AUDIT REPORTS' CONCLUSION REGARDING THE OVERSTATEMENT OF THE COMPANY'S INVESTMENT AND THE PER CENT NON-COMPLIANCE IS GROSSLY IN ERROR

In light of the supporting information provided to the FCC both at the time of the audit and in formal replies from December 1997 to the present, and information regarding items found within the four walls of the central office at the time of the field visits as well as the results of the SAVR inventory process, each of the company's results in this report should easily reflect **more than 97%** of the record items as found.

Immaterial deficiencies in the records are not violations of any FCC rules because the FCC rules do not require a particular form or method of keeping the CPR as long as the essential details are included. Errors such as an incorrect frame identification, floor number or description are not violations of the FCC

[49] See November 1997 letters to the SBC LECs from Mr. Ken Ackerman, FCC, to Ms. B. Jeannie Fry.

rules, and, in any event, such inaccuracies are immaterial to the accuracy of the investment on the books.

Finally, we have been and continue to be available to discuss any or all of the items that the FCC does not understand if any of the documentation provided by the SBC LECs is unclear to the FCC auditors. Finally, we have also invited the auditors back to these locations so that we may demonstrate even more clearly to the FCC the existence of items that have not changed since the date of the field visits.

## IV. THE AUDIT REPORT INACCURATELY DESCRIBES THE FCC'S AUDIT PLANNING

A. The FCC did not obtain a clear understanding of controls and procedures prior to the start of its field work or prior to requesting volumes of data with unreasonable deadlines.

Prior to planning and performing an audit, Generally Accepted Auditing Standards (GAAS) dictate that the auditor obtain a sufficient understanding of the internal control structure of the business in order to determine the nature, timing and extent of tests to be performed.[50] Such information also assists the auditor in efficiently performing the audit. The audit report fails to include the FCC's detailed written audit plan. The auditors' failure to develop and to follow an appropriate and detailed work plan and develop an understanding of the business before conducting the field visits contributed to errors in the grading of the existence of the record items.

Within the information provided on page 7 of each of the FCC's audit reports the FCC states that these overviews were presented on October 30, 1997 at the "[FCC's] request. This is factually misstated by the FCC. The October 30, 1997 systems overview referred to in the FCC's audit report, an overview normally required for auditors to plan and perform an audit prior to the start of field work, took place two months after the FCC had started its field work in August of 1997 and Pacific *volunteered* to provide this to the FCC and not at the FCC's request.

To explain, the FCC notified SWBT on August 7, 1997 that it was planning an audit of SWBT's CPR[51] and it notified Pacific on August 12, 1997[52] that it was planning an audit of Pacific's CPR. The FCC proceeded with its field visits in the following two months of 1997. After the field work was complete, both Pacific

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[50] SAS No. 1, Generally Accepted Auditing Standards, AU § 150.01 (Nov 1972).
[51] See FCC's August 7, 1997 letter from Mr. Ken Ackerman to Ms. B. Jeannie Fry, SBC.
[52] See FCC's August 12, 1997 letter from Mr. Ken Ackerman to Ms. B. Jeannie Fry, SBC.

and SWBT received various data requests[53] that indicated a lack of understanding by the FCC audit staff of the systems used by the companies to maintain their CPRs. Because of these types of data requests and because no detailed systems "walk-throughs" of SWBT and Pacific were completed prior to testing (which is a fundamental audit standard), Pacific and SWBT *volunteered* to provide the FCC with a comprehensive systems overview in order to provide the FCC with a better understanding of the systems and controls at both Pacific and SWBT.[54] This is the six hour overview that took place on October 30, 1997.

B. The FCC's report has not properly portrayed the facts regarding its audit planning and the timing of its sample selection.

The FCC performed its field audits on the sample sites at Pacific and SWBT commencing in mid-August 1997. In October of 1997, after the audit sample had been made and the field work had already been completed on 60 of the 64 central offices, the FCC expressed a need, on short notice, to visit 4 more Central Offices at Pacific. Thus, it is impossible that the FCC could have formed its initial audit plan and selected its sample of SWBT and Pacific offices based on an initial plan to ensure that each stratum was represented by at least 2 central offices. This type of planning caused Pacific and the FCC the additional costs to visit 4 more sites in October on short notice.[55] Again, the FCC's report has not properly portrayed the facts regarding its audit planning and the timing of its sample selection.

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[53] One data request was outside the scope of the audit as stated in Mr. Ackerman's August 7 and August 17, 1998 letters to Ms. B. Jeannie Fry. Specifically, reports were requested for outside plant facilities rather than for hardwire central office equipment. Requests were also made for copies of reports concerning SWBT's annual reconciliation process (a process no longer performed by SWBT due to an improvement in the control systems). Finally, requests were made for voluminous amounts of data that would have taken the companies years to research. For example, see two separate letters to the FCC from SBC, both dated October 3, 1997, as follows: (1) letter to Mr. Joe Paretti from Ms. Jeannie Fry dated October 3, 1997 in response to a separate data request from the FCC on September 9, 1997 for copies of outside plant facility reports; (2) letter to Mr. Joe Paretti, FCC, from Ms. B. Jeannie Fry, SBC, in response to FCC's September 9, 1997 data request to SWBT for copies of annual reconciliation process. (Unlike the other BOCs, SWBT no longer performs an "annuals process" with the improved systems control implemented in 1995.) See also FCC data requests dated September 6 and September 16, 1997 to SWBT and Pacific requesting detailed information for more than 3,000 record items.

[54] The information presented in SWBT's report is also not factually represented. On April 14, 1997, prior to the start of the 1997 audit, SWBT received an oral data request[54] for a brief, general overview for a limited number of the FCC's audit staff. SWBT provided the very general information it understood the FCC was interested in at that time. A formal and comprehensive systems overview took place in October, 1997, two months after the FCC had started its field work in August of 1997

[55] See letter from October 14, 1997 letter from Mr. Ken Ackerman to Ms. B. Jeannie Fry requesting a review of four additional locations at Pacific.

## V. THE INFORMATION PROVIDED REGARDING THE 1994 AUDIT IS INCOMPLETE, MISLEADING AND NOT COMPARABLE TO THE CURRENT AUDIT AND SHOULD NOT BE USED TO DRAW ANY CONCLUSIONS IN THE CURRENT AUDIT

### A. THE SOUTHWESTERN BELL TELEPHONE COMPANY 1994 AUDIT REPORT

Following the completion of the "1994 Audit," the FCC did not provide SWBT with any audit report. Thus, the information issued in this report first comes to SWBT almost five years after the audit was completed by the FCC. SWBT takes serious exception to the timing and the manner in which the first-ever issued report is presented for an audit that took place four years ago. Moreover, SWBT finds that *the FCC has omitted material information* that is necessary for an accurate understanding of any conclusions regarding the 1994 audit. Because much has changed in the last five years, the information about the 1994 audit does not reflect SWBT's current operations.

The audit report states that "the Audits Branch prepared a consolidated audit report regarding the 1994 audit, but the report was not released." [56] SWBT objects to any conclusions being drawn based on an audit report that has never been disclosed. For example, the audit concludes that "the problems" are "pronounced and prevalent" based on the 1994 audit, however, the FCC has not provided any details or any factual basis for these conclusions. In short, the audit report provides a misleading description of the 1994 audit and the company has had no opportunity of explaining or scrutinizing it for accuracy.

The FCC's 1994 Audit used a judgmental[57] sample to audit software costs, right to use fees, firmware costs *and* central office equipment.[58] On the other hand, as noted on page 1 of each of the companies' reports for the 1997 audit, the audit report covers "findings" in hard-wired central office investment and the undetailed and unallocated costs using a statistical sampling procedure. In addition, in 1994, the FCC reviewed more higher dollar items than lower dollar items of equipment. By contrast, the set of audited property records included many low cost items in the 1997 review. Therefore, any comparisons presented in the FCC's December 22, 1998 report, between the 1994 Audit and the 1997 audit, are inherently "apples to oranges" comparisons.

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[56] See fn. 24 of the December 22, 1998 SWBT Audit Report.
[57] See Pacific and SWBT Reports at Appendix A, Page 1. The reports state that the FCC examined a sample of "judgmentally-selected" central office items.
[58] See August 19, 1994 letter from FCC's Mr. Mark Stephens to SWBT's Ms. Karol Sweitzer.

Since the inclusion of information regarding results of the 1994 audit is not comparable to this audit, the inclusion of this information is extremely misleading to any user of the report and should not be used to draw any conclusions in the current audit.

The FCC's report also misstates the facts when it states on page 1 of Appendix A, "We excluded from our sample plug-ins, unspecified items, and any non-COE maintained in the CPR system." As evidenced by the FCC's August 1994 letter[59] and numerous responses filed with the FCC in response to its data requests during this audit, the 1994 audit did *in fact* include a "review of software costs, right to use fees, firmware costs and central office equipment." SWBT also formally provided the FCC with detailed information in response to its data requests regarding its so-called "unspecified items." Therefore, the report is in error when it states that the 1994 audit *excluded* unspecified items.

With regard to the 1994 audit, as the FCC is aware, in the Fall of 1994 its auditors visited only six (6) central offices in St. Louis, Missouri. The FCC's report omits this information and the fact that two auditors conducted the audit of <u>both</u> software and hardwire equipment. The auditors asked SWBT to locate approximately 15 to 20 items in each of the SWBT central offices. With the exception of some of the items in one of the central offices, SWBT was able to show the auditors all the equipment it wished to verify. Therefore, we do not understand how the FCC supports its statement at the top of page 5 of SWBT's report that it "found that SWBT could not locate the assets."

Following the field visits by the FCC's auditors in 1994, SWBT provided detailed information supporting its costs in response to the FCC's data requests. Therefore, we also do not understand how the FCC supports its statement at the top of page 4 of the SWBT report that SWBT "generally, could not support its CPR values."

Since the FCC never provided SWBT with any report of findings or conclusions regarding its 1994 audit until now, SWBT has no idea how the FCC has come to a conclusion that "33.7% of the dollar value"[60] of the equipment contained in the sample could not be found. SWBT takes strong exception to the FCC's conclusion on page 1 of Appendix A when it states that SWBT resolved a difference of $9.2 Million. The FCC has not provided adequate support for its conclusions regarding the 1994 audit.

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[59] Id.
[60] See Report for SWBT at Appendix A, Page 1.

In any event, SWBT maintains that there are serious flaws in the1994 audit process and takes exception to the FCC's first reporting any conclusions regarding the 1994 audit, some five years after its completion. The FCC did so without any support sufficient to draw the stated conclusions or to compare to the 1997 audit and without ever giving SWBT an opportunity to review any of the results of the audit contained in the undisclosed consolidated audit report prepared by the Audits Branch.[61]

Because a proper sampling technique was not employed, drawing any conclusion in this report regarding the 1994 audit is misleading and incorrect. The FCC apparently draws its conclusions about the processes and systems in place in 1994 based upon its notes from a review of only six central offices at SWBT in the city of St. Louis, Missouri. It is also unclear how any variances the FCC believed it found can be used to draw conclusions regarding SWBT's investment in 1994 or compare it with the results in the present audit.

Finally, SWBT takes serious exception to the Audit Report's discussion of the "Duration of the Problem," its contention that Pacific and SWBT's so-called CPR "problems" are longstanding and the related discussion.-[62] This statement in the FCC's report cannot be supported by the evidence presented. Clearly, the FCC has no basis, statistical or otherwise, for this.

SWBT has taken action to significantly improve its records to ensure its investment is properly stated on its books. For example, in its May 22, 1995 letter to the FCC,[63] SWBT provided the FCC with detailed plans it had to improve its records and to reduce the investment listed in the "unspecified" categories. SWBT implemented its plans and voluntarily provided the FCC with a status report on July 17, 1997. [64] As a part of that report, SWBT stated:

> "SWBT completed a review of investment in the following categories: Dummy RATS, Unallocated Other Costs, Temporary CPRs and Undetailed in Detailed Years.[65] As depicted in the attached charts, this review resulted in the elimination or significant reduction of investment in

[61] See Fn 21 of the December 22, 1998 SWBT Draft Report .
[62] See Report for SWBT at Page 3 and 14.
[63] See May 22, 1995 letter from SWBT's Ms. Jane Knox to FCC's Mr. Jose Rodriguez. As noted in the letter, details of SWBT's plans were provided in a meeting with the FCC on May 21, 1995.
[64] See July 17, 1997 letter from Ms. B. Jeannie Fry, SBC, to Mr. Ken Ackerman, FCC.
[65] As explained by SWBT in the May 21, 1995 meeting with the Audits Branch "Undetailed in Detailed Years" expressly meant the undetailed investment since the PICS/DCPR process was implemented at SWBT in 1983. SWBT understood, from the 1968 agreement with the FCC, that it needed to implement detailing in undetailed years only on a "going-forward" basis, as further explained in this response.

these categories. Additionally, Company objectives were established for each category of investment."

## B. THE PACIFIC BELL AND NEVADA BELL 1994 AUDIT REPORT

In contrast to the FCC's 1994 audit of SWBT, following the completion of the "1994 Audit, the FCC *did* provide Pacific Bell and Nevada Bell with audit reports.[66] However, these letters did not include any percentage or summary relating to items "not found." Five years after the completion of the FCC's audit, Pacific does not understand how the FCC supports its statements that Pacific "generally, could not support its continuing property record values."[67] The December 22, 1998 report presents this information to Pacific without support for the first time five years after the correspondence[68] between Pacific and the FCC. Pacific questions the significance of the inclusion of information regarding items "not found" in the current audit report when it was not important enough to include in the 1994 correspondence to Pacific.

Several replies were provided to the FCC by Pacific and Nevada in 1994. In these replies, Pacific described in detail the plans it had to improve its CPR records. The FCC did not provide Pacific with any further information or data requests following Pacific's May 27, 1994 response to the FCC. Also, by the very fact of the existence of correspondence between Pacific and the FCC in 1994 regarding undetailed, the FCC's report is in error when it states that the FCC excluded unspecified items from its 1994 Hardwire Inventory.[69]

Secondly, the FCC's 1994 Audit used a judgmental[70] sample to audit software costs, right to use fees, firmware costs *and* central office equipment in four central offices. On the other hand, as noted on page 1 of each of the companies' reports for the 1997 audit, the audit report covers "findings" in hard-wired central office investment and the undetailed and unallocated costs using a statistical sample. Therefore, any comparisons presented in the FCC's December 22, 1998 report between the 1994 Audit and the 1997 audit, are also inherently "apples to oranges" comparisons.

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66 See letters to Ms. Sherry Herauf, Pacific, from the FCC as follows: Mr. Jose Rodriguez's letter of March 3, 1994; Mr. Jose Rodriguez's letter of April 11, 1994; Mr. Mark Stephens' letter of May 10, 1994.

67 See Pacific Draft Report at Page 5.

68 See Pacific replies from Ms. Sherry Herauf to the FCC as follows: March 23, 1994 reply to Mr. Jose Rodriguez letter of March 3, 1994; May 9, 1994 reply to Mr. Jose Rodriguez letter of April 11, 1994; May 27, 1994 reply to Mr. Mark Stephens letter of May 10, 1994.

69 See Report at Appendix A, Page 1.

70 See Reports for Pacific and SWBT at Appendix A, Page 1. The report states that the FCC examined a sample of "judgmentally-selected" central office items.

Also, the FCC's 1994 audit report to Pacific states as follows:

> "It is difficult to physically inventory PB's switching investment and other related investment purchased from manufacturers other than AT&T. For example, the CPRs for digital switching equipment purchased from Northern Telecom are deficient in that they do not provide a specific description or number that enables the auditor or engineer to properly identify the equipment from the CPRs…"
>
> "When Pacific Bell purchases equipment from AT&T, the items are maintained in the PICS/DCPR system with an adequate description to properly locate and identify the equipment from the CPRs. However, when PB purchases equipment from manufacturers other than AT&T they are not providing a unique identification or description in the CPRs which enables a positive identification of the equipment from the CPRs."
>
> "As the companies initially recorded the switching investment in the PICS/DCPR system, there was sufficient detail. This was basically true because **AT&T was the provider of the equipment and the designer of the PICS/DCPR system.** However, as the company PB (Pacific Bell) began obtaining equipment from other manufacturers, this equipment did not have the same automated information as provided by AT&T…"[71]

This information from the 1994 audit is especially relevant to explain the causes of some of the undetailed investment that was beyond the control of the company.

Because a proper sampling technique was not employed, inclusion of any results from the 1994 audit of Pacific is misleading. As the FCC is aware, it is drawing its conclusions about the processes and systems in place in 1994 based upon its notes from a review of only four central offices at Pacific and Nevada. It is also unclear how any variances the FCC believed it found could be used to draw conclusions regarding Pacific's investment in 1994. Therefore, it is improper to include conclusions it has extrapolated based upon an extremely limited review of Pacific's equipment and include them in the current audit report.

The FCC should acknowledge and give Pacific credit for the action it has taken to significantly improve its records to ensure its investment is properly stated on its

[71] See April 11, 1994 letter from the FCC's Mr. Jose Rodriguez to Pacific's Ms. Sherry Herauf (emphasis added.)

books. For example, in its April 11, 1994 letter to Pacific,[72] the FCC instructed Pacific to establish and provide the FCC with procedures to properly retire and amortize its cross connection investment and to detail the undetailed investment. Pacific responded with its plans[73] and, as the FCC is aware, Pacific completed these plans by the dates established with the FCC. As a result, for example, Pacific reduced the balance of its cross connect investment to a $0 balance and reduced its undetailed investment 85% over four years from $181.5 Million in 1994 to $27 Million in 1997. [74]

Pacific takes serious exception to the incomplete and misleading manner in which information is presented in an audit report for an audit that took place four years ago. Finally, Pacific takes serious exception to the inference that Pacific's COE accounts may have been overstated for many years. [75] This statement in the FCC's report cannot be supported by the evidence presented. Clearly, the FCC has no basis, statistical or otherwise, for this.

[72] See April 11, 1994 letter from the FCC's Mr. Jose Rodriguez to Pacific Telesis' Ms. Sherry Herauf.
[73] See May 9, 1994 letter to Mr. Jose Rodriguez from Ms. Sherry Herauf.
[74] See May 2, 1997 reply to FCC's April 14,1997 data request.
[75] See Report for Pacific at Page 3 and 14.

## VI. THE AUDIT FAILS TO TAKE INTO CONSIDERATION THE FCC'S PRIOR RULINGS REGARDING 'NON-SPECIFIC' (E.G. UNDETAILED) INVESTMENT

The audit report takes the position that the line-items in the CPR that contain no description of either the equipment or its location are in violation of the FCC's rules for maintaining property records. The audit report fails to consider material information regarding the FCC's prior knowledge of the undetailed investment, including rulings and waivers relating to the undetailed investment. In connection with these prior rulings and waivers, SWBT and its pre-Divestiture affiliates explained that the embedded equipment would not be detailed.

The report fails to explain why the FCC has changed its position concerning the undetailed investment. The FCC has known about the undetailed investment for many years at least since 1968 and yet, the FCC has never taken the position until now that the existence of the undetailed investment that pre-dated the mechanized property record system (e.g., PICS/DCPR) would constitute a violation-[76] of the FCC's Rules, nor had the FCC previously taken the position that undetailed embedded investment would have to be detailed by a date certain.[77] This is an unexplained reversal of the FCC's previous position. Additionally, any suggestion that the company just write off nearly $1 Billion in undetailed investment is unjustified and unwarranted. To do so, places the cart before the horse, since it must first be inventoried.

### A. EQUIPMENT PREDATING IMPLEMENTATION OF PICS/DCPR MECHANIZED PROPERTY RECORD PLAN

In both Pacific and SWBT's reports, the FCC states that "these controls, which have been in place **for many years**, do not ensure that all investment recorded in the carrier's COE accounts [are] associated with equipment that is in service."[78] The Audit Report contends that "the Company's procedures have changed very little over the past 20 years."[79] These statements imply that the FCC had knowledge of a long history, but the material details of this 30 year history have been omitted from the report. In fact, the Audit Report incorrectly

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[76] See Reports for Pacific and SWBT at Page 1.
[77] By "embedded" here, we are referring to the equipment that existed prior to the effective date of the PICS/DCPR detailed property record keeping system at each of the BOCs (i.e., 1968 for Pacific Bell and 1983 for SWBT.
[78] See Reports for Pacific and SWBT at Page 3.
[79] SWBT Report at Page 15.

claims that the FCC first became aware of the undetailed investment during its 1994 audit.[80]

The report omits additional information that the FCC has *had for many years* regarding the current record keeping system. The PICS/DCPR system was developed by AT&T and introduced to the FCC at least as early as 1967. [81]

In March, 1967 [82] the FCC granted a waiver of Part 31 to permit two Bell operating companies to introduce a new detailed continuing property record plan on a "going forward basis" in selected areas on a trial basis. Specifically, the ruling from the FCC stated "the provisions of Part 31 of our Rules are waived to the extent necessary to permit [the two BOCs] to introduce in a selected area in each company a detailed continuing property record of central office equipment on a "going forward basis" which may reflect the use of retirement units and retirement procedures which differ from the requirements of Part 31 and from those described in Accounting Letter M-223.[83]

A copy of the new detailed property record plan for central office equipment, then documented as AT&T Comptroller's Letter M-295 ("Outline of Plan for a Mechanized Detailed Property Record of Central Office Equipment") was formally filed by AT&T with the FCC in June 1968.[84] The M-295 filed with the FCC made it very clear that PICS/DCPR would only include details for equipment installed after the date a BOC implemented the new detailed property record plan. For example, the M-295 states as follows:

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[80] See SWBT Report at page 14.
[81] In fact, a few years before 1967, AT&T had reviewed with the FCC the concept of a using a mechanized detailed property record system instead of the general Continuing Property Record procedures that had been filed with the FCC perhaps as early as the 1940s. The general Continuing Property Record procedures were documented in the AT&T Comptroller's Letter M-223 ("Outline of Procedures for Maintaining Continuing Property Records"). During the decades following AT&T's initial filing of the M-223, the BOCs, including SWBT and Pacific, made numerous filings with the FCC describing their individual property record plans, including any specific differences from AT&T's M-223 filing. These filings reflect the FCC's close supervision of all of the details of the BOCs' Continuing Property Record plans. In the mid-1960s, AT&T apparently determined, or was persuaded by the FCC, to implement a different property record system for central office equipment that would include more detailed information in a mechanized system. It appears that AT&T first approached the FCC concerning the concept of a detailed property record system in 1963.
[82] See March 14, 1967 letter from FCC's Secretary Don F. Waple to Mr. Alexander L. Stott, Vice President and Comptroller, AT&T and September 11, 1968 letter from AT&T's Vice President and Comptroller, A.L. Stott, to Mr. Ben Waple, Secretary of the FCC.
[83] As found in AT&T Comptroller's Letter M304B (August 31, 1982), Part 1, Attachment 1, Letter M223 is entitled "Outline of Procedures for Maintaining Continuing Property Records."
[84] See letter dated September 11, 1968 from A.L. Stott, Vice-President and Comptroller, AT&T to Mr. Ben Waple, Secretary, FCC.

> "For hard-wired equipment, details are included in the record on a **going-forward basis**, that is, for **plant added after the start of the plan** . . .. Additionally, the mechanics of the plan are such that details can be included in the record at any time for any previously undetailed amounts, if it becomes practicable to compile the details. Undetailed investment is reflected in the record by location, account and year of placing."[85]

The M-295 also provided detailed instructions regarding the treatment of the "Undetailed Investment" that would exist by reason of the "going-forward" implementation. For example, the M-295 instructs the BOCs to assign the property record number 40000 to all Undetailed Investment entries in PICS/DCPR. In its instructions concerning the procedures for the cutover to PICS/DCPR, the M-295 also provided instructions for determining the starting balances of the Undetailed Investment entries.[86]

Following the introduction of the detailed property record on a trial basis in Westchester, New York, South Carolina and California, AT&T reported positive results and formally requested approval of the plan and permission to use the plan in other parts of the Bell System. In its September 11,1968 request[87] to the FCC, AT&T stated:

> "This letter is a detailed description of the plan, and includes procedure recommendations and associated forms for establishing and maintaining a record of property record units by quantities, costs, etc. In contrast to this new type of record, the continuing property record now maintained for

[85] See M-223, May 1968, Section 1.07.
[86] See M-295, May 1968, Supplement, Section S1.0705, at S1-7, which states as follows: "Starting balances for undetailed plant in service investment as of the close of the year just prior to cutover should be determined and recorded as follows:
(a) Establish total amounts of investment of plant in service as of the close of the year by locations, accounts and years of placing by reference to the Record of Actual Cost by Locations….
(b) Determine the plug-in and tool amounts as of the close of the year by locations, accounts and years of placing.
(c) Obtain the summary of Account 100.1 open-order amounts…
(d) Subtract Items (b) from (c) from Item (a).
(e) Record the resulting amounts, by locations, accounts, and years of placing as inputs to the mechanized record under property record number 40000 and equipment category 040."
[87] See letter dated September 11, 1968 from A.L. Stott, Vice-President and Comptroller, AT&T to Mr. Ben Waple, Secretary, FCC.

> central office equipment as recommended in Comptrollers Letter M-223 …a record of costs by building locations, by subaccounts…"

In this letter, AT&T described the detailing in the new plan as follows:

> "For hard-wired equipment **the record will include plant added after the adoption of the plan** in each company; that is, on a **going-forward basis**. . . . Accordingly, we will have two continuing property record plans for central office equipment. The newer plan encompasses the continuation of the older type of record and the method of operation thereunder, including the determination of retirement amounts, for plant (other than capital tools and designated plug-in items) placed prior to the adoption of the new plan. Hard-wired equipment not recorded in detail initially may be included under the new plan whenever it becomes practicable to compile such details."[88]

In its September 11, 1968 request, AT&T specifically committed to inform the FCC before beginning to use the new plan in other geographic areas. AT&T also stated as follows:

> "Further, should management consider it desirable to establish the record for equipment installed prior to the generally effective date, the companies will advise the Commission of such action."

The FCC's letter ruling of December 24, 1968, which approved AT&T's new property record plan, described the new plan as well as the then existing manual property records, as follows:

> "The continuing property-record now being maintained for central office equipment is a record of costs by building location, by subaccounts of account 221 . . .. Under the new plan all capital tools and designated plug-in items, including those placed prior to the start of the plan will be recorded in detail. **The record**, after adoption of the plan by each company, **will include hard-wired equipment on a going-forward basis. . . .**Accordingly, you will have two continuing property-record plans for central office equipment, viz., the

[88] See letter dated September 11, 1968 from A.L. Stott, Vice-President and Comptroller, AT&T to Mr. Ben Waple, Secretary, FCC. (emphasis added)

> new plan and the continuation of the older type record . . ..You indicate that there **may be** included under the new plan, **whenever it becomes feasible** to compile details, hard-wired equipment not recorded in detail at the outset."[89]

This new property record plan was gradually adopted by each of the BOCs, but, in the case of each BOC, prior to its adoption of the plan a notice was sent to the FCC to inform the FCC of the adoption and extent of use of the new detailed record plan by a particular BOC. In fact, the FCC's December 24, 1968 ruling required 30 days advance notice from each BOC in order for that BOC to be permitted to implement the detailed property record plan. Specifically, the letter ruling stated as follows:

> 'We understand that each of the Bell Companies will inform the Commission of the adoption and extent of use of the detailed record plan at least 30 days prior to the date the new detailed record generally becomes effective."

As required by the December 24, 1968 ruling, SWBT's October 1982 notice informed the FCC of "the adoption and extent of use of the detailed record plan." Specifically, SWBT notified the FCC as follows:

> "[T]his is to inform you that the Southwestern Bell Telephone Company intends to maintain a detailed record of central office equipment, effective January 1,1983, as specified under the mechanized plan outlined in AT&T Comptroller Letter M-304B, Outline of Procedures for Maintaining a Mechanized Detailed Continuing Property Record of Central Office Equipment."[90]

SWBT notified the FCC of its intention to adopt the AT&T plan as a method of detailing on a going forward basis, as specified in the AT&T plan, except in the case of equipment in two field reporting codes, 157C and 257C, for which SWBT informed the FCC that it would also establish a detailed property record for equipment "placed in service prior to January 1, 1983." Thus, according to SWBT's notice the only hardwired equipment for which pre-1983 details would be

[89] See letter dated December 24, 1968 from Kelley E. Griffith, Chief, Domestic Rates Division to Mr. Alexander L. Stott, Vice President and Comptroller, AT&T, at page1. (emphasis added)
[90] See October 13, 1982 SWBT Comptrollers Letter from Mr. R.N. Schoonmaker to Mr. William J. Tricarico, Secretary, FCC. Note: the 1968 correspondence discussed procedures in AT&T Comptroller's letter M-295. AT&T Comptroller's Letter M-304B incorporated procedures for a detailed continuing property record of central office equipment "originally outlined in M-295." (Reference: Part 1-1, M-304B, July 1982).

included under the new mechanized property record plan were these two field reporting codes. Everything else would be entered as specified in AT&T's plan as then documented in the M-304B[91], which was the successor document of the M-295 approved in the 1968 correspondence. To explain, the PICS/DCPR detailed property record system was originally outlined in the M-295 filed with the FCC in 1968. Later, AT&T supplemented the M-295 with the M-304B, which became the primary procedure for ongoing maintenance of PICS/DCPR. After issuance of the M-304B, the M-295 continued in effect as an auxiliary instruction. Although the content of the two accounting letters is substantially the same, the M-295 contained instructions on some matters not covered by the M-304B, such as the procedures for a cutover to the new system for those BOCs that had not implemented PICS/DCPR in the beginning.

The M-304B, like its "auxiliary" document,[92] the M-295, which had been submitted to the FCC in 1968, described the new detailed property record plan as a procedure for detailing central office equipment on a "going forward basis". For example, the M304B, dated August 31, 1982, in a section entitled "Record of Plant Placed Before the Effective Date of the Detailed Property Record," stated as follows

> "Detailed records are maintained for all plug-in type equipment, portable tools and test sets, including those placed in-service before the implementation of the detailed continuing property record. For hardwired equipment, details are included on a **going-forward basis**, that is for **plant added after the implementation** of the detailed continuing property record. Details for any previously undetailed hardwired equipment investment may be added to the record at a later date."[93]

In the second part of the M-304B, it reiterates this same point, as follows:

[91] AT&T Comptroller's letter M304B "Outline of Procedures for Maintaining a Mechanized Detailed Continuing Property Record of Central Office Equipment (August 31, 1982) states in Part 1, Page 1-1, that the "plan for mechanized Detailed Continuing Property Records for central office equipment was developed in 1968 and outlined in Comptroller's Letter M-295 ["Outline of Plan for Mechanized Continuing Property Record of Central Office Equipment']"…"(PICS/DCPR) is a computer-based inventory management system incorporating procedures for a detailed continuing property record of central office equipment originally outlined in M-295."
[92] AT&T Comptroller's letter M304B "Outline of Procedures for Maintaining a Mechanized Detailed Continuing Property Record of Central Office Equipment (August 31, 1982) in Part 1, Attachment 1, lists M-295, "Outline of Plan for Mechanized Continuing Property Record of Central Office Equipment" as one of the "Auxiliary Instructions" to M304B.
[93] M-304B, Section 1.03(emphasis added).

> "For hardwired equipment, details by equipment items are included in the record on a going-forward basis, that is, for plant added after the start of the record . . .. For hardwired plant placed in service before the start of the detailed record, not detailed by equipment items (Property Record Number 040000), the record shows in-place cost dollars by years of placing within subaccount and location. . . .The mechanics of the detailed property record are such that details can be included in the record at any time for previously undetailed amounts if it becomes practicable to compile the details. . . . Notification must be provided to the FCC at least 30-days in advance of any such detailing of previously undetailed investment."

Pacific Bell implemented the detailed record keeping system in 1968 and Southwestern Bell implemented the detailed record keeping system in 1983. The audit report has omitted all of the forgoing information known to the FCC, including especially the "going forward" nature of the implementation of the detailed property record plan and information relating to the October 13, 1982 notice sent to inform the FCC prior to the effective date of the new detailed record keeping system at SWBT.

Thus, SWBT and Pacific take strong exception to the omission of additional data which is extremely relevant to the audit report's conclusions concerning the PICS/DCPR system, its inadequacy and its compliance with the FCC's rules. The FCC clearly allowed the detailed record keeping plan to be implemented so as to detail the equipment on a "going forward basis." As noted above, SWBT did not implement the PICS/DCPR record system until 1983 and, as the FCC is aware, more than 99% of that $923.8 Million in undetailed pre-dated 1983.

In CC Docket No. 78-196, [94] the FCC adopted a requirement that carriers maintain separate subsidiary records for analog and digital equipment beginning January 1, 1988. In 1986, SWBT filed a request for a waiver[95] of this requirement to implement the analog/digital subsidiary records "since it [would] be economically prohibitive for Southwestern Bell to modify its records to comply with this subsidiary record keeping requirement within the timeframe established in the <u>Report and Order."</u>

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[94] "In the Matter of Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies (Parts 31, 33, 43 and 43 of the FCC's Rules), Report and Order, released May 15, 1986.

[95] Amended Motion or Waiver of Section 32.2232(c) of the Commission's Rules and Regulations, filed December 5, 1986, CC Docket No. 78-196 ("1986 Waiver Request.")

SWBT described generally the going-forward nature of its implementation of PICS/DCPR and its unique circumstances, given that it was the last of the BOCs to implement it. For example, SWBT explained as follows:

> "[W]hen the hardwired (HW/DCPR) portion of PICS/DCPR was implemented by Southwestern Bell in 1983, no economic justification existed for loading of details for embedded hardwired investment . . .. Southwestern Bell chose to defer the detailing of this investment, which required translation into a mechanized format. Instead of detailing this investment, the original book costs of all circuit equipment less the details for plug-ins recorded in PICS/DCPR, were checked for reasonableness and entered into HW/DCPR as the undetailed, embedded hardwired investment. Hardwired circuit additions made since January 1, 1983 have been entered into HW/DCPR in a detailed manner . . .."[96]

In the sworn affidavit[97] filed by SWBT in support of the waiver request, SWBT's witness stated:

> "[D]ue to economic business decisions, Southwestern Bell did not start its implementation of this [PICS/DCPR] system until 1981. Thus, while some of the former Bell System companies have been on a mechanized inventory system since the late 1960s and have equipment records in a detailed form, Southwestern Bell lacks detailed records for nearly half of its circuit equipment…
>
> "I estimate that it will take Southwestern Bell approximately 15 years before natural attrition makes the cost of separating the then remaining undetailed equipment into two categories nominal, even if it is still not economically justified...
>
> "Based on my divestiture experience and knowledge of available personnel and their experience level, I estimate that it would take at least $17.5 million to <u>reclassify</u> Southwestern Bell's hardwired circuit equipment <u>into analog and digital</u> investment categories." [emphasis added]

In this Waiver request, SWBT explained how it intended to disaggregate the digital and analog equipment. To reclassify the existing hardwired circuit

[96] 1986 Waiver Request, at 6.
[97] 1986 Waiver Request, Affidavit of Harold C. Fleisher III, dated September 12, 1986.

equipment into digital and analog, it was not necessary to perform the detailing of the equipment to the level of detail contained in PICS/DCPR. In fact, SWBT explained that detailing all of the circuit equipment would have taken too long and would have been cost-prohibitive. Instead, SWBT proposed an alternative using certain shortcuts in order to accelerate the disaggregation of analog and digital circuit equipment. The FCC granted the waiver permitting SWBT to use these shortcuts to disaggregate the circuit equipment over a 3 year period. In granting the waiver, the FCC did not require SWBT to perform the detailing. In fact, in the Affidavit attached to the waiver request, SWBT distinguished its short-cut method from the detailing required by PICS/DCPR:

> "Bay equivalent level analysis is a much simplified, averaging technique which has been used before to meet similar requirements with short intervals. A property record unit analysis (there are many units in a typical bay) would be several-fold more costly."[98]

The FCC granted the waiver [99] to permit SWBT to use its proposed alternative for classifying the remaining circuit equipment into analog and circuit. In granting this waiver request, the FCC expressly acknowledged the undetailed treatment of the equipment that pre-dated the 1983 implementation of PICS/DCPR. For example, the FCC's ruling stated as follows:

> "Southwestern, unlike most other subject carriers, did not start maintaining detailed inventory records necessary to provide this type of information until recently . . ..[Y]ou state that due to your lack of detailed inventory records you are unable to reclassify all of your hardwired circuit equipment by January 1, 1988."

Therefore, the FCC granted SWBT a waiver to permit the alternative procedure, an analog/digital disaggregation, over a 3-year period beginning in January 1988.

Significantly, the FCC's ruling did not comment on SWBT's treatment of the undetailed investment for equipment that pre-dated implementation of PICS/DCPR. One would expect the FCC would have addressed the subject of a violation or noncompliance in the records that were the subject of a request for a waiver. Instead of finding a serious deficiency in SWBT's record keeping, the FCC granted SWBT a waiver to use an alternative simplified procedure to

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[98] Id. n. 2.
[99] See 1987 letter from FCC's Mr. Gerald Brock, Chief Accounting & Audits Division to Mr. Keith E. Davis, Attorney, SWBT.

separate the pre-1983 analog and digital circuit equipment without performing the PICS/DCPR detailing.

The audit report ignores the FCC's prior knowledge of the undetailed investment and contradicts the entire history of the development of the mechanized detailed property record system and the FCC rulings relating to that type of investment.

Thus, the current draft of the audit report is in error when it states that Pacific and SWBT are in violation of the FCC's rules in the treatment of the amounts of undetailed investment associated with equipment placed before the effective date of the new property record plan.

The FCC cannot conclude that there is an "apparent violation" where the FCC has known of a practice for almost 30 years and approved of it in a Bureau ruling.

Likewise, the FCC's criticism is unfounded considering that the FCC has repeatedly been told how the pre-PICS/DCPR undetailed was being handled, but for 30 years, the FCC has not advised any of the BOCs, or previously, AT&T,[100] that there was any problem with this approach.[101]

## A. SOUTHWESTERN BELL TELEPHONE COMPANY

More recently, during the 1994 audit and the current audit, the FCC has also been kept informed of SWBT's plans with regard to the undetailed investment. For example, as noted above, at the time of the audit, SWBT informed the FCC auditors that approximately 99% of the $923.8 Million of SWBT's undetailed investment represented investment that pre-dated the implementation of PICS/DCPR in 1983. Also, as noted in a response to a data request that SWBT sent to the FCC in September 1994: [102]

> "SWBT implemented PICS/DCPR in 1983. All investment prior to 1983 was recorded as a lump sum by year placed under the CPR for Undetailed Investment…
>
> "All 1983 and prior investment is still classified as undetailed because the specific records to track the costs of each item are not easily accessible.

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[100] According to accounting records, AT&T had nearly $1 Billion in undetailed in 1983, at divestiture, in the SWBT central offices alone.

[101] Due to the passage of time, some records relating to this history are difficult to find and the memory of the few remaining witnesses to the early history has faded, and thus, SWBT and Pacific must reserve the right to supplement the factual background as they discover additional pertinent information.

[102] See September 7, 1994 letter to FCC's Astrid Carlson from SWBT's Ms. Karol Sweitzer.

> The investment will remain in undetailed until the equipment is retired. Some equipment placed after 1983 is recorded in PICS/DCPR as Undetailed Investment until it can be detailed with a specific CPR…
>
> "Procedures have been established for detailing undetailed investment in years placed after 1982. The detailing takes a considerable amount of manual work. The market areas have not had the time or personnel to complete the detailing of undetailed investment…
>
> "The investment for equipment placed in service prior to 1983 will be retired when an engineer determines that the equipment should be retired. The engineer will determine the cost associated with the equipment based upon specific records or assumptions made regarding equipment purchases in the particular year specified…"

Following a meeting with the FCC on May 21, 1995, SWBT voluntarily provided the FCC with written information[103] regarding the enhancements implemented to SWBT's practices and procedures for maintaining its central office CPRs. However, the enhancements described by SWBT in its meeting and in its letter of May 22, 1995 were not intended to address the pre-1983 undetailed investment, which SWBT continued to handle in a manner consistent with the history of the undetailed set forth above, as well as the FCC's rulings in 1968 and 1987. SWBT once again explained in its meeting plans, consistent with plans it formerly had provided to the FCC, that the undetailed investment prior to 1983 would be classified as undetailed until it was retired. The FCC did not react to this 1995 correspondence from SWBT in the manner SWBT would expect if the FCC truly considered the undetailed investment to be a serious violation. If the Audit Report's view of the undetailed investment had been applied consistently in connection with the 1994 audit, SWBT, at a minimum, would have received a letter of warning about the undetailed investment, which was then an even larger amount.

Also, in its April 1997 response to the FCC's March 20, 1997 data request, SWBT again informed the FCC that "SWBT implemented PICS/DCPR in 1983. All investment prior to 1983 was recorded as a lump sum by location by year placed in the CPR for Undetailed Investment."[104]

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[103] See May 22, 1995 letter from SWBT's Ms. Jane Knox to FCC's Mr. Jose Rodriguez. See also, July 17, 1997 letter to FCC's Mr. Ken Ackerman from SBC's Ms. Jeannie Fry. The July 1997 letter provided the FCC with updated information to the commitments voluntarily made in SWBT's May 22, 1995 letter.
[104] See SWBT response to Question 2b of the March 20, 1997 data request.

As the FCC is also aware, on March 10, 1998 and March 26, 1998, SWBT voluntarily committed to implement a special analog SAVR program to inventory 100% of all its analog central offices by the 1 Q 1999. This special SAVR program includes identification or retirement of the undetailed in all of its analog central offices. And, in fact, because of its efforts, SWBT has reduced its undetailed investment by nearly 85%, from $1.5 Billion in May of 1994 to $207.3 Million in November of 1998. As a part of this commitment, SWBT also volunteered to provide and has provided the FCC with quarterly monitoring reports. [105]

SWBT's treatment of the undetailed investment is consistent with the 1968 ruling. Further, SWBT is making efforts to prudently and reasonably identify or retire its undetailed investment on an accelerated basis and has kept the FCC informed of its efforts. Finally, the SBC LECs have, on more than one occasion, asked the FCC to review more closely the SAVR inventory and accounting process, an inventory process that has revealed millions of dollars of working investment. Therefore, we take exception to any and all allegations or claims in the audit report that the undetailed investment is not in compliance with the FCC's rules, as well as allegations or implications that SWBT has been in "apparent violation" of the FCC's rules or that its property records are deficient by reason of the undetailed investment or any recommendations that SWBT simply write off hundreds of millions of dollars of working plant in service.

## C. PACIFIC

In its April 11, 1994 letter to Pacific, the FCC states that

> "Investment should be detailed with a proper location and description as required by our rules. In order to accomplish this PB should research its supporting records and physically inventory the existing undetailed investment before detailing such investment."[106]

In compliance with the FCC's letter, Pacific committed in its May 9, 1994[107] reply to the FCC that it would research and identify the amount of investment recorded as undetailed prior to 1969. As also noted in its reply of May 1994, Pacific agreed to complete this work on the undetailed investment by the end of 1994. Pacific also replied to the FCC that, as far as ongoing use of CPR 040000 for investment after the implementation of PICS/DCPR (i.e., 1968 for Pacific), the

[105] See letters dated July 1, 1998, May 22, 1998, September 17, 1998 and December 16, 1998 from Ms. B. Jeannie Fry, SBC Communications Inc. to Mr. Ken Moran, Chief, Accounting Safeguards Division, FCC.
[106] See April 11, 1994 letter from FCC's Mr. Jose Rodriguez to Ms. Sherry Herauf, Pacific.
[107] See May 9, 1994 reply from Ms. Sherry Herauf, Pacific, to Mr. Jose Rodriguez, FCC.

undetailed investment classification was part of the Bellcore PICS/DCPR software and should be retained for use for such things as processing end of year adjustments.

No time limit was established in the FCC's 1994 letter to Pacific nor has any time limit ever been established by the FCC. However, Pacific established a timetable at its own initiative. The FCC has been kept informed of Pacific's plans and of Pacific's results with regard to the unspecified investment, including the undetailed.

Finally, to further control the amount of undetailed investment, and as explained in its October 30, 1997 presentation to the FCC, Pacific implemented the SAVR program as part of Pacific's ongoing effort to enhance the accuracy of its record keeping. The SAVR program also includes an emphasis on identifying the non-specific investment, including the undetailed investment.

Pacific's treatment of the undetailed investment is consistent with the 1968 ruling. Further, Pacific prudently and reasonably identified or retired the vast majority of its undetailed investment on an accelerated basis in 1994 and continues to pursue this effort via the SAVR process.

Therefore, we take exception to any and all allegations or claims in the audit report that the undetailed investment is not in compliance with the FCC's rules, as well as allegations or implications that Pacific has been in violation of the FCC's rules or that its property records are deficient by reason of the undetailed investment.

## VII. STATEMENTS CONCERNING THE VALUE OF THE AUDIT ARE MISLEADING AND INACCURATE

The FCC's Reports state that

> "By describing the plant's specific locations and providing references to invoices, work orders, and other support documents, the continuing property records provide a key aspect of the audit trail for the plant accounts and facilitate regulatory review of, *inter alia*, incumbent LEC charges, depreciation rates, and certain jurisdictional separations and cost allocations."[108]

The report omits supporting rationale for how the continuing property record "facilitates" regulatory review of a price cap Local Exchange Carrier charges.

[108] Draft Reports at Pages 3-4.

LEC charges are governed by price cap regulation not costs or investment.[109] The audit reports[110] make several references to various regulatory functions which the FCC believes could be impacted by incorrect COE records. Nonregulated cost allocation, separations, depreciation rates or other various regulatory functions are cited. In a price cap regulatory environment plant accounting detail is no longer of paramount importance as prices charged for regulated services are regulated instead of the company's costs of which plant investment is a part. [111]

## VIII. THE SBC LECs HAVE PROVIDED SUFFICIENT INFORMATION TO SUPPORT THE ACCURACY AND COMPLETENESS OF ITS DETAILED CONTINUING PROPERTY RECORDS

Under "Specific Record Keeping Requirements," of the Reports, the FCC states:

> "Supplemental records include invoices, work orders, and engineering drawings which support the information in the CPR."[112]

This statement regarding the FCC rules' requirement for invoices or work orders are errors because they overstate what the rules require. SWBT and Pacific have searched the FCC's rules and cannot find any clear statement that the companies must produce a specific type of document to support its detailed continuing property records

Section 32.12, "Records" of the Commissions rules states that

> "(c) The Commission shall require a company to maintain financial and ***other subsidiary records*** in such a manner that specific information, of a type not warranting disclosure as an account or subaccount, will be readily available. When this occurs, or where the full information is not otherwise recorded in the general books, the ***subsidiary records*** shall be maintained in ***sufficient detail*** to facilitate the reporting of the required specific information. The ***subsidiary records***, in which the full details are shown, shall be ***sufficiently referenced*** to permit ready identification and examination by representatives of this Commission."

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[109] In fact, estimates are allowed when the original cost of property cannot be ascertained, such as the case of successor or assign of the properties. § 32.2000 (f)(4); and thus, the required documentation would be minimal if estimates are used.
[110] See Pacific and SWBT Reports at Page 1.
[111] Refer to Attachment C, "COE Records," for a further discussion of these individual issues.
[112] SWBT Report, at 3-4.

Section 32.2000(c)(2)(xiii) states that "The ***records supporting the entries*** for indirect construction costs shall be kept so as to show the nature of the expenditures, the ***individual jobs*** and accounts charged, and the bases of the distribution."

Section 32.2000 continues to state that the companies' basic property records should show "(i)The identity, vintage, location and original cost of units of property;…and (iii) Any ***other specific financial and cost accounting information*** not properly warranting separate disclosure as an account or subaccount but which is needed to support regulatory, cost, tax, management and other specific accounting information needs and requirements."[113] It also states that:

> "(3) The basic property records shall consist of (i) continuing property records and (ii) ***records supplemental*** thereto which together reveal clearly, by accounting area, the detailed and systematically summarized information necessary to meet fully the requirements of paragraphs (e)(1) and (e)(2) of this section."[114]
>
> "(7) . . . (ii) The ***records supplemental*** to the continuing property records shall disclose such service designations, usage measurement criteria, apportionment factors, or **other data as may be prescribed by the Commission in this Part or other Parts of its Rules** and Regulations. Such data are subject to the same general controls and standards for auditability and support as are all other elements of the basic property records."[115]

The FCC's rules state in 32.2000(f) *Standard practices for establishing and maintaining continuing property records*--(2) *Property record units* that "the continuing property record shall reveal the description, location, date of placement, the ***essential details of construction***, and the original cost" and that the CPR and the "other underlying records of construction costs shall be so maintained that, upon retirement of one or more retirement units or of minor items without replacement when not included in the costs of retirement units, the actual cost or a reasonably ***accurate estimate*** of the cost of the plant retired can be determined."[116]

As noted above, the rules do not specify that the supplemental records in the Basic Property Record must include a particular type of document. Supplemental

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[113] 47 C.F.R. §32.2000(e)(1)(emphasis added).
[114] Id. §32.2000(e)(3)(emphasis added).
[115] Id. § 32.2000(e)(7).
[116] Id. § 32.2000(f)(2).

records do not necessarily have to include every conceivable type of document (invoices, work orders and drawings). The audit report should state that the rules do not say specifically which documents are required as supplemental records.

We take exception to the FCC's inclusion of any statement regarding actual work orders or invoices as the only method of complying with record keeping requirements for the life of the assets. This is simply incorrect . In 1986, the FCC eliminated virtually all of its document retention guidelines in Part 42. The FCC's standards must recognize that document retention is not regulated in the same manner as before 1986 and some documents may not be available depending upon the carrier's retention procedures. As noted in the FCC's Rule 42.7, "each carrier shall retain records identified in its master index of records for the period established therein."[117]

Storage and retrieval of records is a very complex task. Even data warehouses cannot store everything. If the FCC wishes companies to maintain the actual documents and it wishes to specify which documents must be retained, it must open a rulemaking to establish specific document retention requirements in its rules.

## IX. THE FCC'S REPORT DOES NOT CORRECTLY PORTRAY THE SAVR PROJECT AND FAILS TO INCLUDE COMPLIANCE GOALS OR STANDARDS OF MATERIALITY

### A. STATEMENTS REGARDING THE SAVR PROJECT

On Page 5 of SWBT's report, the FCC states regarding the SAVR process that "The goal of this project is to conduct and complete asset verification and, as found necessary, the retirement of COE in SWBT's central offices by the 1st quarter of 1999." Appendix A, page 2, states that SWBT has implemented SAVR in central offices "with greater then [sic] $100 million in investment." These statements are in error.

As noted in meetings[118] with the FCC, SAVR is being performed on all of Pacific's central offices and will complete by the end of the 1st quarter of 1999. SAVR is being performed on all SWBT digital central offices with $10 Million or more in investment. The digital SAVR project at SWBT will complete by the end of the 3rd quarter of 1999. The analog SAVR project was performed on all

[117] 47 C.F.R. § 47.7, Retention of other records.
[118] For example, as noted in the July 1, 1998 letter to Mr. Ken Moran, FCC, Chief, Accounting Safeguards Division, presentations that included the SAVR commitments were provided to the FCC on March 10, 1998 and March 26, 1998.

analog central offices; it was originally scheduled to complete by the end of the 1st quarter of 1999, but was completed ahead of schedule in December of 1998.

Also, on page 4 of Pacific's report, the FCC states that "Of this amount, however, only $1,646,400 was retired prior to June 30, 1997, the date of the CPR audited in 1997." The amount listed in the report, $1,646,400, is in error and understated according to the response provided to the FCC on May, 4,1998 the correct amount that should be listed in the report is $19,136,600.[119]

Aside from the errors in the report concerning SAVR, when one considers the size and cost of the SAVR inventory project (more than $1 Million) that both Pacific and SWBT have undertaken, the FCC's description of SAVR in its report is very incomplete and not accurate.

B. THE FCC'S AUDIT INCLUDED A REVIEW OF PLUG IN EQUIPMENT

The reports' description of the scope of the audit differ between Pacific's report and SWBT's report. As noted on page 6 of SWBT's report, the FCC's auditors were able to audit plug-ins. The SWBT report notes that "SWBT includes certain non-deferrable plug-ins as part of its hard-wired inventory." This information is omitted from the Pacific report. The same is true for Pacific and, in fact, non-deferrable plug-ins were audited at both the Pacific and the SWBT locations.

C. THE AUDIT REPORTS HAVE OMITTED ANY COMPLIANCE GOALS OR PRESET STANDARDS OF MATERIALITY TO TEST AGAINST

The FCC has omitted any information regarding standards it believes are reasonable for compliance. If the FCC auditors have found some better method of keeping records or if it has discovered a generally occurring level of accuracy, this would be relevant to both establishing business goals that are compliant as well as judging whether the FCC auditors' expectations of accuracy are realistic and whether the standards in the rules and procedures are reasonable.[120]

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[119] In its April 15, 1997 reply to the FCC's letter of March 20, 1998, Pacific provided preliminary information and noted that a supplemental reply would be made since the remaining records would have to be accumulated manually and this could not be completed by the date the FCC wanted a response. Once it had completed the accumulation of all records, Pacific provided a supplemental response to the FCC on May 4, 1998 that clearly showed $19,136,600 was retired as of the end of the 2nd quarter of 1997.

[120] This is not intended to suggest that the confidentiality of any data from other specific audits should be compromised. However, consistent with obligations under Section 220(f), the auditors should describe the general circumstances prevailing in the industry as found in other audits, as they pertain to the audits of SWBT and Pacific.

The report also fails to include a sufficient description of the FCC's audit standards. As reflected in Appendix C of both reports, the standard of proof is unclear. In some cases, the FCC wants proof "certain" and in other cases they are willing to take a count of the total number of items on a floor in a central office. The report states that some items were "not adequately described in the CPR" but fails to mention the standard of review being used to determine whether a description is sufficient. The report also fails to point out that some items cannot be labeled with a number because they are too small to have a label or number. Similarly, the audit report fails to include the standards used for adjusting results (such as inconsistencies between the auditors on-site at the central offices and between the audit teams back at the FCC's offices).